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BOSTON UNIVERSITY

GRADUATE SCHOOL

Thesis

THE DEVELOPMENT OF INVESTMENT TRUSTS IN THE UNITED STATES

Submitted by

James Pierce Cavin

(B.B.A., Boston, 1927; Ed.M., Harvard, 1929)

In partial fulfilment of requirements for the degree of Master of Arts

1930

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PART I -- INVESTMENT PRINCIPLES

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INVESTMENT, SPECULATION AND GAMBLING

There are probably no words more misunderstood than the three terms: investment, speculation and gambling. They confuse the financial authority and the man in the street. Their meanings are vague and shifting, both in the talk of the market-place and in treatises on investment. Yet the writer believes that reasonable distinctions can be made, and such are essential, for nowhere is the jumble of meanings more distressing than in connexion with investment trusts. This paper treats of investment trusts as mechanisms of investment, and definitely excludes superficially similar schemes which mask speculative or gambling ventures with a phraseology stolen from worthier enterprises.

The Investor

Investment is the commitment of funds to an economic undertaking for the purpose of securing an annual return by reason of the use of these funds in pro-

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The Investor

Investment is the commitment of funds to an economic undertaking for the purpose of securing an annual return by reason of the use of these funds in pro-

duction, under such conditions that the premium paid for risk does not outweigh the true investment return. The investor wants assurance that his principal will remain intact, yet at the same time he desires as large a return as is consistent with the regularity of that income and with the security of his principal. If his principal were absolutely safe, the investor would get the pure interest of the economist. But there is no such thing as a riskless investment and the return to the investor always includes, in addition to the true interest, a premium for risk. The greater the risk assumed, the greater the jeopardy of the principal; and as the mind of one purchasing securities becomes focused on extraordinary gains in disregard of the integrity of his principal, that person ceases to be an investor.

The Speculator

There is next, the speculator. In some respects he resembles the investor. In gaining his end, as defined above, the investor must act with reasoned judgment, but so also must the speculator. The investor always places his funds in a productive enterprise; so likewise may the speculator. But real differences are apparent. The speculator may put his money into a productive enterprise, but in making his commitment he ac-

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cepts an unusual hazard; a risk which is balanced in his mind by the promise of exceptional return, but which at the same time endangers the safety of his principal. This shouldering of large risk is speculation.

There are other things that mark the speculator. A person may not put his funds definitely into production, but may simply trade in securities; buying low with hope of selling high; deriving his gain or suffering loss through the exigencies of price change. The speculator acts rationally; he consciously assumes the risks of uncertain enterprises, going in with his eyes open and weighing carefully his chances. He is no fool and does not assume risks of a magnitude unwarranted by his economic status.

From this description of the speculator's activities a definition may be constructed. Speculation is (1) the placing of funds in an economic undertaking where the lure of large reward for risk-bearing is paramount to the investment motive of moderate, regular return and safety of principal, or (2) the buying and selling of securities with the object of securing a gain through favorable price changes; in either instance the handler of the funds consciously taking chances that he has carefully weighed, and in neither instance accepting

a hazard unwarranted by his financial status.

The Gambler

Last of all comes the gambler. He hopes to make gains out of the same situations as does the speculator, but the gambler is irrational. He is "above all, the blind chance-taker . . . . The gambler either cannot or does not calculate the chance of success or failure."[1] And there is one more distinction. The gambler often plays the fool, taking risks which his financial strength does not warrant, wild chances that may result in his impoverishment, leaving him unable to care for those to whom he owes a social duty.

A formal definition may read: gambling is (1) the placing of funds in securities which represent a high degree of economic risk or which hold the lure of favorable price-change, but in either instance trusting blindly to fortune, or (2) bearing a risk out of all proportion to the financial position of the person making the commitment.

THE THEORY OF DIVERSIFICATION

Pure Interest and the Risk Premium

Pure interest and a premium for risk have been mentioned as comprising the investment return. The first is simply a price resulting from the action of the

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world demand for savings upon the world supply; and the market rate changes as these determining forces change. The second is in the nature of an insurance premium to compensate for probable loss of principal. There is an element of risk in every investment, and if this risk could be calculated with precision, it would be possible to fix a risk premium for each type of investment which would exactly offset all losses of principal. In other words, if in a given type of investment, one $100-unit in each fifty $100-units would lose its entire value annually, each unit would carry a 2% risk premium to counteract the inevitable loss. Of course, an investment fund would have to be large enough to purchase fifty units, and these units would have to be widely distributed among the industries offering this type of investment, in order that the so-called law of averages would work itself out. "Under these conditions the net return to the investor would be exactly the pure interest. The excess of risk premium above pure interest would exactly offset the losses of principal. There would be no enhancement of principal, no loss of principal."[2]

Diversification

This leads to the principle of diversification which is basic to the investment trust device. It has

[2] Dewing, A. S. The Financial Policy of Corporations, p. 1177

[4] Dewing, A. S. The Financial Policy of Corporations, p. 1177

long been observed that investors of large funds distribute those funds among many enterprises. The true significance of this practice, as explained above, is that enough risk premiums are assembled to counterbalance the inevitable losses.

There is a common fallacy in connexion with the distribution of investment funds that may well be taken up here. Some people have the idea that any sort of haphazard distribution is conducive to safety. This position is untenable. If a man with five-thousand dollars places one-fifth of his fund in each of the following: the shares of a risky oil venture, the stock of a new public utility holding company, the first-mortgage bonds of a transcontinental railroad, the obligations of a sizeable mid-Western city, and the preferred stock of the little local shoe factory, there is no guarantee that risk premiums will offset losses -- the risk factor is not uniform. On the other hand, if he should purchase the first lien bonds of five large public utilities, with those obligations carrying equivalent risk factors, there would be a real appeal to the so-called law of averages.

There is also one other aspect to the theory of diversification,excellently stated by Professor Dewing. He says, "Were it possible to divide a fund into a vast

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number of separate units, and place these units in every industry in the country and in proportion to the industry's contribution to the national wealth, then the fund would increase or decrease in proportion to the increase or decrease of national wealth . . . . Moreover, the wider the distribution, the more certain it is that the fund, as a whole, will not be extinguished for it is inconceivable that our economic life should be extinguished without the extinction of the race."[3]

INVESTMENT PROFIT

The Return to Skilled Management

Pure interest and a premium for risk have been discussed as elements in the investment return. There is possible yet another -- economic profit. Modern economic theory has recognised the reward of management as a proper division of the national dividend. In the ordinary conduct of a business undertaking, this share represents payment for the manager's contribution of the vital elements of organisation, direction and judgment. The investor of funds has the opportunity to exercise true business foresight, and in so doing to secure from his commitments a true business profit -- a gain in excess of the pure interest return and the risk premium.

[3]Dewing, A. S. op. cit., p. 1190-1

This securing of an investment profit has to do with the estimation of the risk factor. In numerous instances the market estimate of the worth of an investment does not coincide with the true value of that investment. It is either too high or too low. Only the investor of unusual insight and far-reaching knowledge can detect the discrepancy. If a certain security yields 5.4% at the current price, and the interest rate is 4%, the premium for risk is apparently 1.4%. But if the true status of the investment is such that a yield of 5% is adequate, there remains an excess gain of 0.4%. Herein lies the source of true business profit. The skilled investor discovers this differential and secures the extra return by purchase of the undervalued security. Generally speaking, this profit is not a permanent element. The forces of the market tend eventually to bring market prices into line with intrinsic values. (There are, however, some securities that seem to be permanently overvalued or undervalued; such condition being due to long standing prejudice in the mind of the investing public or to artificial demand as in the case of legals.) The discerning investor sees the opportunity before it is apparent to the market as a whole; he beats the market in a real sense. The investor here exercises the same

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kind of judgment as does the manager of some industrial enterprise who sounds conditions in his own field so that his endeavors may be in harmony with basic economic forces. The investor who can with frequency make similar judgments will secure substantial profits. On the other hand, the discriminating investor will avoid those securities wherein the market has underestimated the risk factor, and so avoid incurring losses.

It is to be observed that investment profit or loss may be thought of in terms of yield or in terms of capital value. A security is selling for $1000. The annual income from it is $75, a yield of 7.5%. Assume this security to be undervalued, that the yield should be normally about 6%. Eventually the forces of the market will tend to fix the price of this security at its normal value, about $1250. The purchaser of the security at $1000 could take his profit in either of two ways. He could continue to receive his $75 annually, figuring his yearly investment profit to be $15, or he could sell out for $1250, thus making a single profit from capital appreciation. A reverse process would occur in the case of an overvalued security.

Opportunities of the Cycle

Opportunity for profit-taking in investment

is closely linked with the periodic ups and downs of industry -- the familiar business cycle. Two things connected with the cycle are important to the investor seeking profit: the movements of the interest rate and the psychological attitude of the business and financial world. The upward swing of the cycle is marked, in the first place, by a rising interest rate, and secondly by the prevalence of business optimism engendered by large profits and increasing sales. On the downward course of the cycle the reverse is true. The interest rate falls, while the world of business and finance is pessimistic.

Considering the upward movement of the business cycle, it is obvious that insofar as the return on an investment is pure interest, the market price of that investment will tend to fall. Assume that a person buys for $1000 a 4% bond devoid of risk at a time when the interest rate is also 4%. He would be paying precisely what the bond is worth. But if some months later a business boom should send the rate to 8%, the price of his bond would tend to drop to $500.

To take a more likely case, assume a 6% bond with a yield composed of 4% pure interest and 2% compensation for risk, selling at $1000. Improving business conditions send the interest rate to 6%. If the estimation

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of the business hazard does not change, the bond will fall in price to about $750. But brighter prospects for business generate an optimism that tends to underestimate the full extent of economic risk. If in this instance, the risk, while actually one in fifty, should be adjudged one in a hundred, the premium would drop to 1%. This decline in the risk premium would in some degree offset the rise in the rate of interest. The market price of the bond in question would thus tend to settle around $860.

Stocks and Bonds

It will readily be seen that increase in the interest rate and underestimation of risk are counteracting influences. Furthermore, it is apparent that securities whose return is composed largely of pure interest will tend to fall in price, while those carrying a considerable risk factor will tend to advance. In other words, high-grade bonds will tend to recede in price as the business cycle moves upward, while securities of considerable risk(especially common stocks)will tend to experience price enhancement. It is also evident that precisely opposite conditions obtain when the cycle is on the down-grade. The interest rate drops, risks are overestimated; bond values rise, stock prices fade.

Investors able to discern intrinsic values can

take advantage of these conditions. As the bottom of the cycle is neared, high-priced bonds should be sold and the proceeds put into undervalued stocks. At the top of the cycle this process should be reversed, inflated stocks should be sold and high-grade bonds of distant maturity acquired.

But the astute management of an investment fund means something more than profit-taking. It was remarked that the investor is much concerned with keeping his original commitment intact. There is no such thing as an investment that can be put away and forgotten. To put, say half a million dollars into various enterprises and be able ten years later to liquidate for an amount equal in purchasing power to the original sum requires knowledge, insight and ceaseless vigilance. Individual corporations grow old and die: whole industries rise and fall. Sound investment management demands that the investment fund be continually shifted so that the commitments shall be always with strong corporations and in "industries which produce goods or services so much demanded by the contemporary social order that their market price remains consistently above the cost of production."[4]

Summary and Transition

These matters of diversification and manage-

[4] Dewing, A. S. op. cit., p. 1227

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* Dewing, A. S. op. cit., p. 1527

ment may be summarised briefly. Diversification means the distribution of the investment fund among securities carrying a like risk premium and sufficiently numerous really to compensate for hazards assumed; or, theoretically, to distribute the fund so widely and completely that the investment return will coincide with the economic fortunes of the nation or of the world. Management refers to the application of skill and knowledge to the securing of a profit by taking advantage of discrepancies between market prices and true values; and also shifting the investment fund in such manner as to preserve the original fund intact despite the vicissitudes of industry and the varying value of the dollar.

It is evident that the effective diversification requires an extremely large investment fund, and that superior management implies the mastery of a vast and intricate science. The practice of investment as a science is not an occupation for the man in the street with his little store of savings. The wealthy investor is taken care of. He can invest on a large scale and can command expert management. Yet the small investor is definitely in the field and he wants all that he can get. The solution is unmistakable. If individuals in considerable numbers pool their resources, a large fund may be created; and a large fund means diversification,

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skilled management, and greater return.

The demand for an investment device that will provide these advantages of large-scale investment has been met by schemes generally known as investment trusts. "Broadly, the investment trust may be defined as an organisation for the collective investment of the funds of numerous individuals in numerous securities."[5] The two principles basic to its operation are those that have just been discussed -- diversification and skilled management. This definition is a very general one. It will be seen later that many projects designated as investment trusts do not adhere strictly to these principles, and also that the term "investment trust" is somewhat of a misnomer. But this simple definition is adequate for the time being.

[5] Fowler, J. F. American Investment Trusts, p. 20

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[2] Bowler, T. P. American Investment Trusts, p. 20

PART II -- THE BRITISH EXPERIENCE

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GENERAL

As far as anyone knows, the Société Générale de Belgique, founded at Brussels in 1822, was the original investment trust[7]. But it was not on the Continent that the first extensive development took place. Great Britain is the true home of the investment trust. It was there that this financial device first became numerous; first attained an important and permanent place in the financial structure. It was there that organisation, managerial technique and investment standards were furthest advanced.

In describing the British experience, reference is made at some points to Scottish trusts and at others to English trusts. No real distinction is intended. Development in the two countries was practically simultaneous and closely parallel. What is said of one applies to the other.

[7]Federal Reserve Bulletin 62, (January, 1921)

I

The Economic Stimulus

The rise of the investment trust in Great Britain is not hard to explain. The basic economic factor lay in the foreign trade situation which grew up after the Napoleonic Wars. Domestic production was enormously increased and a great excess of goods flowed out in the export trade. A large favorable balance was constantly maintained, turning Great Britain into a great creditor nation and necessitating the export of capital. The increasing productivity of British industry brought prosperity and the saving classes accumulated a large surplus for investment. The home market could not absorb it all. Furthermore, the yields of foreign securities were extremely high and alluring speculative possibilities abounded. Of no small consequence was the fact that the rate on British Consols declined as political conditions became stabilised and the government grew strong. In 1860, when the first Scottish trust was formed, the rate on British Consols was about 3%, while the obligations of foreign governments yielded upwards of 5%, and strong private enterprises abroad, such as large railroads, yielded even more.[1] Lastly may be mentioned the vigorous policy of colonial expansion which focused the minds of the British people on the possibilities of great develop-

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ments overseas.

Historical Sketch

Throughout the nineteenth century enormous sums of British capital flowed to foreign fields. From the early years down to the 1860's investment was haphazard, individualistic and highly speculative. A number of the wealthier capitalists were able to purchase adequate investment information and to diversify their holdings, but the middle-class investor of moderate means could do neither, and, possessed by the gambling fever of the times, blindly flung his savings into one or two enterprises on the basis of glowing circulars and hopeful expectations. The British public paid a heavy price. Default followed default; panic succeeded panic. Losses were tremendous; thousands were ruined.

It began to dawn in the minds of investors that the purchase of foreign securities must be based on thorough analysis, and that some form of diversification was desirable. The investment trust arose to meet the need. In 1863 appeared the London Financial Association and the International Society. At about the same time investment trusts were being started in Scotland. For the next twenty years development was slow, scarcely more than a dozen investment trusts being listed on the London

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Stock Exchange at the end of that time.[3]

In the decade from the early 80's to the early 90's the speculative frenzy broke out again. The investment trusts greatly extended their activities and increased rapidly in number. Unfortunately, this expansion was largely along unsound lines. There was little restriction upon trust management; fraud, incompetence and recklessness crept in. The condition of many organisations was shaky, and the successive shocks of the Baring crisis of 1890 and the American panic of 1893 hit the British trusts hard. The American panic was disastrous for the British trusts because of their large holdings of American securities. "The two situations combined made it necessary for many British and Scottish trusts to indulge in a careful revaluation of their securities . . . . The result of such a general revaluation of investments was both unpleasant and salutary."[4]

With the lessons of the past in mind, the British trusts entered a period of sound development which extended down to the beginning of the World War. During these years there was evolved a technique of management and organisation which secured the investment trust a place of importance in the scheme of domestic finance, and made British practice the international stand-

[3] Grayson, T. J. Investment Trusts, p. 14
[4] Ibid., p. 17

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ard. The World War interrupted all progress. Many trusts sold their foreign holdings and put the proceeds in government obligations; others turned their securities over to the government in exchange for the guarantee of a fixed return. Despite hard times, the trusts came through in good shape, and recent statistics[5] indicate that they are more than holding their own.

TECHNICAL ASPECTS

The Form of Organisation

Up to this point no explanation has been given why this particular device should be called a "trust." The reason is apparent. "The early British investment trusts were in truth just what the name implies -- informal associations of individuals entrusting their investments to one person [sometimes to several persons] who occupied a fiduciary position."[6] The investment associates would designate certain persons of supposed integrity and financial ability as trustees, receiving in return certificates of participation entitling them to a share in the trust fund proportionate to their contributions and a like share in such investment return as the trustees would be able to earn. Usually the trust fund would be limited to a fixed sum. If the fund was oversubscribed, a second, but legally distinct, trust would

[5] Layton, G. C. & Barrons 11, (May 21, 1928)
[6] Fowler, J. F. op. cit., p. 4

be created bearing the same name as the first and utilising the same trustees. The life of these trusts was limited, liquidation taking place automatically at the end of fifteen or twenty years.

Things changed in 1879 with the passage of the Companies Acts, which in effect established a general corporation law for the United Kingdom. The investment trusts were brought within the scope of the act, and since that time have assumed the form of limited liability companies, though they still continue to be designated as "trusts." It is interesting to note that it is the lack of uniform requirements of incorporation that has raised the issue of public regulation of investment trusts in this country.

The Evolution of Management

As noted above, the managements of many British trusts were guilty of numerous financial sins during the developmental period. These managements were frequently invested with sweeping powers, and little supervision was exercised over their activities. As long as profits were forthcoming, no questions were asked. In a time of bubbling optimism and frenzied speculation, untried and untrained men were entrusted with the custody and investment of great funds. It is no wonder that

evil results ensued. Fraud was common. Typical activities were: the use of trust funds for personal speculation, the passing of non-cumulative dividends to cut a melon later for the benefit of the management shares, the lending of money to the unworthy enterprises of friends. Worst of all was the incompetency. Struck with the gambling fever, commitments were made to unsound enterprises, diversification was ignored, new ventures of a doubtful cast were financed, controlling interests were purchased, and some trust managements actually undertook to operate business enterprises.

How organisations so conducted fared in the crashing markets of the 90's is easy to infer. But the investment trusts did not pass from the financial scene. There were a few reasonably well-managed trusts and a goodly number of the others were able to save themselves by drastic revaluation of securities and general reorganisation of administration. The British investing public learned one thing: "Management is primary. Its character, antecedents, responsibility and investment experience can make or unmake any investment trust."[7]

Since that time conditions have been reversed. The outstanding characteristic of the British trusts has been the excellence of their management. The direction

[7]Winston, A. British Investment Trust Experience and Its Lessons For America, 31 Annalist 931-2, (Dec. 14, 1928)

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of the trusts has been in the hands of men of integrity and ability; men who are conscious of the responsibility of their office; to whom the management of a portfolio is an applied science; who recognise that investment is not speculation nor gambling, nor the promotion and operation of commercial enterprises. A technique and tradition of good management has grown up in Great Britain.

British Principles

Years of experience have yielded certain valid principles which are usually incorporated, explicitly or tacitly, in the policies of the better trusts. They may be listed as follows:

(1) World-wide distribution of the portfolio. -- This provides geographical diversification. Poor conditions in one part of the world are likely to be counterbalanced by extraordinary prosperity in some other part. It also enables the trusts to take advantage of opportunities to secure a true investment profit. Excellent opportunities for extra return lie in the fact that demands for capital are constantly springing up in widely scattered and remote regions where funds are scarce. Those who can supply capital at once reap the customary reward of the seller who is first to market. Many times there are irrational prejudices against investment in certain locali-

ties(distance or some other factor)causing the return on capital there to be abnormally high. Those who are true judges of economic values are likely to gain an extra return in such areas.

The published percentages of two British trusts show typical geographical distribution.[8]

Industrial & General Trust, Ltd.
March 31, 1926

Great Britain	37.74%
South America(excluding Argentina)	14.77
British Dominions & Dependencies)	14.70
Argentina	11.67
United States of America	8.71
Europe(excluding Great Britain)	4.82
Asia and Africa(excluding British Dominions and Dependencies)	4.64
Mexico and Central America	2.95
	100.00%

Investment Trust Corporation, Ltd.
May 1, 1928

Great Britain	34.7%
British Dominions and Dependencies	6.8
United States of America	15.9
Cuba	1.7
Argentina	11.7
Brazil	5.5
Other South American countries	4.2
Mexico	0.5
Central America	1.0
Continental Europe	15.2
Other countries	2.8
	100.0%

It should also be noted that British diversification is widespread from the numerical point of view. Professor Grayson found that the average number of invest-

[8] Robinson, L. R., Investment Trust Organization and Management, p. 273

ments held by the typical British trust was 425.[9]

(2) Restriction on the concentration of funds. -- The percentage of the investment fund which can be placed in any one industry, in any one country or region, or in any one type of security is usually specified in the charter of the trust. This is obviously a means of enforcing diversification.

From a survey of 149 leading British trusts, Dr. Leland Rex Robinson presents the following statistics on charter requirements concerning the amount of the investment fund that may be placed in any one security:[10]

	Companies.
" 1. No restriction placed on the amount which may be invested in any one security	67
2. Not more than 5% of the total may be invested in any one security. (14 of the 22 companies except British Government securities.)	22
3. Not more than 10% of the total may be invested in any one security. (8 of the 19 companies except British Government securities.)	19
4. Not more than 5% of the combined share and debenture capital or 10% of the subscribed capital--the phrase"whichever is greater"being added in most cases--may be invested in any one security. (10 of the 19 companies except British Government securities.).	19
5. Miscellaneous.	22
Total.	149 "

(3) Restriction of the acquisition of interests in a single enterprise. The exact nature of this

[9]Grayson, T. J. op. cit., p. 77-8
[10]Robinson, L. R. op. cit., p. 270

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limitation is also usually stated in the charter. It is for the purpose of preventing the trust management from securing control of any concern. The management is thus prevented from assuming directive or administrative duties extraneous to the main business of investment management.

(4) Substantial purchases of securities unquestionably sound and readily marketable. -- The general adherence to this policy keeps the trust in the field of true investment where it belongs. It assures a steady and certain income at all times, and it keeps the trust in liquid condition. This last enables the trust to secure immediate cash with which to take advantage of special investment opportunities.

This tendency to accumulate sizeable amounts of strong securities is shown by the relatively large bondholdings of the British trusts. The figures from eight representative companies showed the following:"

Bonds	54%
Preferred Stock . .	20%
Common Stock. . . .	26%
	100%

Internal Policies

The British show a similar conservatism in matters less directly concerned with the management of the portfolio.

(1) Borrowed Capital. -- Practically all

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British trusts obtain a good part of their capital through the public sale of debentures. These obligations usually carry a low rate of interest. This means that a large part of the earnings will be available for distribution of the ordinary(common)shareholders. The amazingly high returns paid on the ordinary stock of numerous British trusts are in no small degree attributable to this policy of operating with borrowed capital. The reason for the high investment standing of the British trust debentures lies in the fact that large stock equities protect these obligations.

Most people are familiar with the significance of equities as affecting the investment value of corporate obligations. Assume the following balance sheet:

Total Assets	$250,000	Debentures	$100,000
		Common Stock	100,000
		Surplus	50,000
	$250,000		$250,000

It is apparent that the claims of the stockholders amount to $150,000. It is equally obvious that their interests(their equities)serve as protection to the bondholders. The assets might shrink to $125,000. The equities of the owners would be largely swallowed up, but the bondholders would still be secure. On the other hand, if assets should increase to $300,000, equities would rise and the bondholders' position would be

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strengthened. The general investment principle follows: the larger the equities behind a given corporate obligation, the higher the investment standing of that obligation. All this is recognised by British trust management, and a characteristic stipulation of investment trust charters is that the issue of debentures shall not exceed the share capital. Recent figures(January 1, 1928)for thirty representative English trusts, and twenty-five Scottish reveal the general practice.[17]

English Trusts

Debentures	31,121894	44%
Preference Stock	20,138,075	28%
Ordinary Stock	19,903,215	28%
Total	71,163,184	100%

Scottish Trusts

Debentures	22,506,671	49%
Preference Stock	11,102,034	31%
Ordinary Stock	9,041,356	20%
Total	45,650,061	100%

Besides this long-term borrowing through debentures, there is usually some provision for temporary bank borrowing, but this practice is for the most part circumscribed. A frequent restriction is limitation of temporary borrowing to 10% of the share capital and surplus.

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English Trusts

Debentures	£1,121,894	44%
Preference Stock	£0,158,079	28%
Ordinary Stock	£3,905,815	28%
Total	£7,185,184	100%

Scottish Trusts

Debentures	£2,508,871	49%
Preference Stock	£1,102,034	31%
Ordinary Stock	£0,041,386	20%
Total	£5,650,091	100%

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the general public. They get the debentures. The original organisers hold most of the stock. They first issue a simple type of share which is later split up into preferred and ordinary, but still representative of the original ownership.

(2) Reserves and Dividends. -- Among the British trusts the policy of creating large reserves is almost universal. Practically all capital gains, gains realised through the sale of securities at a profit, are kept in the business(unrealised capital gains are not counted at all). Such a procedure eventually builds up the investment fund and ultimately results in big dividends on the ordinary stock, besides increasing the equities behind the debentures and serving as a general protection against financial mishap. If the reserve gets too large, it may be distributed as an extra dividend or capitalised for the benefit of the shareholders. The method of paying dividends is an interesting one. Payments are commonly semi-annual. The first is called the interim dividend, the other, the final dividend. In the case of the preferred stock, the dividends are usually of equal size, but in the case of the ordinary shares, the interim dividend is moderate while the final one is much larger.

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(3) Economy of Operation. -- The British trusts keep expenses down. From his analysis of sixty-three trusts, Grayson reports that "In only eight instances does the expense of management exceed £10,000 a year, and this covers trustees' and directors' salaries, and compensation for managing secretaries, stenographers, and clerical assistants."[13] He finds also that these companies show an average ratio of expense to income of 6.44%.[14] Basing his calculations on issued capital, Robinson finds that for thirty leading London companies the average ratio of management expense to capital is 0.46%, while for twenty-four leading Scottish companies it is 0.41%.[15]

Several factors are at work to keep costs down. Most important is the practice of group management. Interlocking directorates and joint managers bring about the centralisation of direction for the portfolios of many trusts, thus spreading administrative costs over a large fund. Another element is the low cost of marketing securities. The securities of most British trusts stand high in public esteem and new issues are quickly taken up. Such a condition frequently allows the direct sale of new securities without the intermediation of profit-taking bankers. Lastly, long experience has reduced many

[13] Grayson, T. J. op. cit., p. 64
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managerial activities to routine which enables performance at minimum cost.

Other Income and Other Types

So far, the investment trust has been considered as an organisation that devotes itself solely to the investment and reinvestment of a fund in a large number of securities for the purpose of securing a regular income from interest and dividends, and at times deriving a profit from the sale of appreciated securities. Such an organisation is a "pure" investment trust. But most companies listed as investment trusts in Great Britain are not 100 per cent "pure." Frequently, while devoting most of their energies to legitimate investment activities, many trusts undertake side lines such as the performance of ordinary trust functions(registrar, transfer agent, trustee)or the participation in underwriting syndicates. As long as these activities are entered into cautiously and are not allowed to encroach on the main business, they may prove an easy and welcome source of income. But if they are engaged in too extensively, administration of the portfolio is likely to suffer, and the company becomes a hybrid, not strictly classifiable as an investment trust.

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as investment trusts, are not entitled to such classification from the point of view of investment science. Usually these companies center their activities in some special field, and within that field they frequently purchase controlling interests, and may even go to the extreme of owning and operating individual enterprises. For example, there is the Rubber Plantations Investment Trust, Ltd. which not only deals generally in the shares of rubber companies, but even operates rubber plantations in India and tea plantations in Sumatra. Grayson aptly remarks, "Investment trusts of this type, no matter how cleverly they may be managed, cannot be considered conservative or attractive from a purely investment standpoint, although from a speculative point of view they may offer and give greater rewards than those trusts which restrict their activities to holding and dealing in investment securities."[1]

Growth and Earnings

The steady growth of the British companies shows clearly that the investment trust is no mere financial fad. In 1886 there twelve trusts listed on the London Stock Exchange; these had an aggregate capital of £6,500,000. By 1890 the number in Edinburgh and London combined was between fifty and sixty. At the beginning

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of the World War there were nearly a hundred. Although the war was a severe testing for the British trusts, figures for 1927 show 125 investment trusts with a total paid-in capital of over £150,000,000.[17] The number of British trusts listed in Keane's Manual for 1929 was 152, with a capital of £227,000,000.[18] The latest estimate puts the number at 170(104 English, 66 Scottish), and the capital at £269,000,000.[19]

Under the present capitalistic order we judge economic fitness by the test of net profits. By this test the British trusts make a fine showing. The following statistics[19a] give a general idea of earnings at the present time, especially do they show the steady recovery made since the World War. Analysis of the earnings of a number of the largest trusts of Great Britain(25 English, 23 Scottish)show the following earnings on issued capital:

	English	Scottish
1922	5.79%	5.23%
1923	6.33	5.75
1924	6.02	6.30
1925	6.29	6.62
1926	6.42	6.71
1927	6.77	6.75
Average	6.27%	6.23%

The second table shows the percentage of net earnings to common stock, and also reveals the fact that the British trusts still follow their traditional policy of building up reserves.

[17] Badger, R. E. Investment, p. 542
[18] Keane's Manual of Investment Trusts, 1929
[19] Keane's Investment Trust Monthly 75 (December, 1929)
[19a] Winston, A. op. cit., p. 931-2

British Trusts

	per cent earned on common	per cent of earnings carried to surplus
1922	9.25	3.23
1923	10.46	4.40
1924	7.79	3.11
1925	8.46	3.09
1926	8.77	2.79
1927	10.89	3.18
Average	9.27	3.30

Scottish Trusts

	per cent earned on common	per cent of earnings carried to surplus
1922	7.23	1.88
1923	8.04	2.84
1924	10.09	4.40
1925	11.25	4.53
1926	11.74	4.89
1927	12.88	4.79
Average	10.20	3.89

The last table shows still more clearly the remarkable advance that the trusts have made since the war, and also reveals the well-known fact that the shares of most British trusts are subject to capital appreciation. (The present value column is on the basis of a £1,000 investment in 1913.)[20]

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	Present Value	1914 Rate	Present Rate
Army & Navy Investment Trust. .	1,905	8.5%	15%
British Investment Trust. . . .	1,704	14.0	21
General Investors & Trustees. .	3,535	5.0	16
Guardian Investment Trust . . .	2,042	5.5	11
Mercantile Investment & General Trust	2,520	6.0	15
Investment Trust Corporation. .	1,982	12.25	20
Metropolitan Trust.	1,609	12.0	19
U. S. Debenture Corporation . .	2,036	10.0	15

* * * *

The general course of British development has been indicated. Part III deals with the investment trust in the United States. It will become apparent that the British experience has been influential in shaping American policies and practices. The British trust is the standard, it represents orthodoxy in the field. The British trust has proved its worth, it affords a basis for comparison. Innovations in this country must be able to show superiority over traditional methods before one is justified in hailing them as genuinely progressive steps.

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U. S. Debenture Corporation . .	2,036	10.0	15

* * * *

The general course of British development has been indicated. Part III deals with the investment trust in the United States. It will become apparent that the British experience has been influential in shaping American policies and practices. The British trust is the standard, it represents orthodoxy in the field. The British trust has proved its worth, it affords a basis for comparison. Innovations in this country must be able to show superiority over traditional methods before one is justified in hailing them as genuinely progressive steps.

PART III -- THE AMERICAN EXPERIENCE

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GENERAL

Redefinition

In Part I the investment trust was rather loosely defined as "an organisation for the collective investment of the funds of numerous individuals in numerous securities." A more exact statement is necessary. The following definition is offered:[1] the investment trust is an agency by which the combined funds of different investors are placed in a variety of securities, scientifically selected by skilled management, for the purpose of ensuring safety of principal through diversification, of securing a steady income from interest and dividends, and of obtaining profit through capital appreciation; but in no instance assuming a controlling interest or any kind of managerial responsibility in the enterprises whose securities are purchased. This definition will prove sufficient for all practical purposes. Any organisation departing very far from the requirements can usually be classified under another heading, although in the present

[1] Cf. Schreiber, H. E. The Accounts of An Investment Trust, 47 Journal of Accountancy 161-73, (March, 1929); Also; Robinson, L. R. op. cit., p. 13-4

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chaos of American growth, baffling borderline cases appear which are simply unclassifiable.

The Terminology Controversy

As pointed out earlier, the term "trust" is not an especially accurate designation of the type of organisation under consideration. Fowler puts the situation clearly. "The modern investment trust in Great Britain and, for the most part, in the United States does not contain the element of trusteeship or personal responsibility. In the majority of cases, there is no trust relationship between the buying public and the investment trust. Under strict interpretation, therefore, the term 'investment trust' is a misnomer."[1]

Some people seem to think that the word "trust" should be avoided in all instances where fiduciary relationship is not actually present. A false impression is created in the minds of the buying public. The purchaser of stock in an investment trust organised under general corporation laws stands in the same relation to the trust as does the stockholder in any industrial enterprise incorporated in a like manner. But the purchaser is likely to think that the label "investment trust" implies some peculiar fiduciary relationship between himself and the organisation, whereby his funds are protected by unusual

[1] Fowler, J. F. op. cit., p. 2

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Fowler, L. F. op. cit., p. 2

safeguards. From the strictly logical point of view, there is much to be said in favor of setting up a new and precise terminology that will distinguish organisations embodying a real trustee element from those that do not. Some of the financial journals have recently attempted to introduce such terms as: investment company, investment trust company, security investment company.

This writer sees no particular reason for attempting to produce a brand new terminology. The term "investment trust" has been established through long usage. It really means something in the investment world. Furthermore, the growth of language does not proceed according to the laws of formal logic. If the word "trust" is appropriate, it will survive; if not, some other term will displace it. For instance, there is no reason, outside of an historical one, why big corporations of the monopolistic or quasi-monopolistic types should be called "trusts", but the name adheres just the same. At the present time, the prospectuses of investment trusts usually explain the legal structure of the enterprise quite clearly. Persons of common sense soon find out whether the organisation in which they are interested is a corporation or something else. Those who will not investigate this far are hopeless, they will never understand what

they are doing in the sphere of investment despite all precautions taken in their behalf.

Analagous types

It is not to be thought that the benefits of diversification and the possibilities of expert management were unknown in the United States prior to the recent investment trust movement. Wealthy investors have always spread their holdings widely and employed investment management to watch their securities and to make profitable changes.

The securities of certain enterprises also afford advantages comparable with those afforded by investment trusts. For instance, the obligations and shares of the large public utility holding companies give the purchaser an interest in scores of subsidiary concerns, and an opportunity to participate in the increased earnings incident to growth, and to enjoy the fruits of large-scale management. Another example is the bonds of the Federal Farm Land Banks which rest upon large numbers of individual farm mortgages. Even the savings bank offers the element of diversification in some degree.

Outline of Growth

The growth in the United States has been recent and rapid. As far back as 1893 we find the Boston

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Personal Property Trust, followed by the Railway and Light Securities Company of New York in 1904, and the Alexander Fund of Philadelphia in 1907.[3] Although not technically known as investment trusts, these early schemes had many of the essential characteristics. But prior to 1924 the development was very small. Robinson has compiled figures for American and Canadian trusts down to February, 1929.[4]

Year	Companies Formed
Prior to 1924	12
1924	11
1925	11
1926	14
1927	50
1928	61
January 1929	10
Total	169[a]

The total capital of these 169 enterprises was slightly over $1,000,000,000.

It is extremely difficult to secure accurate statistics on such a rapid development. The growth figures of H. E. Schreiber are inserted for comparison.[b]

Year	Total Number	Invested Capital
1923	15	$ 15,000,000
1924	27	75,000,000
1925	48	150,000,000
1926	69	300,000,000
1927	150	700,000,000
1928 (June)	199	1,200,000,000

[3] Fowler, J. F. op. cit., p. 4
[4] Robinson, L. R. op. cit., p. 548
[a] 10 Canadian
[b] Schreiber, H. E. op. cit.

1929 was the most spectacular year of all. By July the number of trusts in this country was estimated to be 260, with a combined capital of $1,700,000,000.[5] By the end of the year, the capital was close to $4,000,000,000. The number of trusts is unknown, but was probably in excess of 300.

Foreign Investment

The British development was due in large measure to the international trade situation. The investment trust grew up to meet the needs of a country with a heavy favorable balance of trade and an excess supply of investment capital. It was at first believed that the use of the investment trust in the United States would arise out of a similar situation. During and after the World War, the United States became a great exporting nation. Due to the war-stricken condition of European industry and to the high American tariffs on imports, goods did not come in to balance the outflow, and the balance of trade grew heavily in favor of the United States. In order to bring about the necessary equation, large amounts of American capital flowed abroad. The increase of American investment in other countries is shown by the foreign security flotations in the United States from 1920 to 1927.

[5] March, F. O. Activities of Investment Trusts, 129 Chronicle 863-6, (August 10, 1929)

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[1] March, F. O. Activities of Investment Trusts, 129 Chronicle 863-6, (August 10, 1929)

(figures in millions)[6]

1920	$ 448.7
1921	603.2
1922	750.0
1923	311.8
1924	1,050.0
1925	1,100.0
1926	1,032.8
1927(11 months)	1,193.5

Under these circumstances it seemed only natural that the investment trust should be utilised to facilitate the movement of capital. As a matter of fact, the Edge law,passed as early as December, 1919, provided for the Federal incorporation of enterprises to engage in the foreign acceptance business or to operate along investment trust lines. These companies were to start with an initial capital of $2,000,000 and were to be under the supervision of the Federal Reserve Board. Only a few were formed. The First Federal Foreign Banking Corporation is now the only enterprise in operation under this law. It holds a diversified list of foreign securities on which collateral trust bonds are issued.

The investment trust movement, however, did not spread far in this direction. L. M. Speaker advances two important reasons why this was so:

"(1) The United States still remains in many respects a new and partially undeveloped country. For that reason American capital will find favorable oppor-

[6]Badger, R. E. op. cit., p. 693

(figures in millions)

1920	$ 448.7
1921	805.5
1922	750.0
1923	811.8
1924	1,030.0
1925	1,100.0
1926	1,032.8
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tunity for investment at home.

"(2) Since the most of the foreign financing we are doing is in government and municipal bonds, the better class of issues, if the interest rate is attractive, find ready distribution through the direct method via the exchanges."[7]

Reasons for American Growth

Although the investment trust has not developed as a medium for foreign investment, it has had a tremendous growth in American finance, and the reasons for this growth must be sought in the domestic area.

A number of more or less interacting causes seem responsible for the rise of the investment trust. First of all, this country has had a period of sustained prosperity. Even admitting the existence of bad spots such as the agricultural depression and considerable continuous unemployment, it must be granted that in general the American people have recently experienced a very high degree of material well-being, not in the absolute sense perhaps, but certainly relatively as compared with the rest of the world both now and in the past. This increase in the national income has naturally led to an increase in savings, in capital seeking invest-

[7] Speaker, L. M. The Investment Trust, p. 101

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[2] Speaker, L. M. The Investment Trust, p. 101

ment. Especially important is the fact that much of this new capital is in the hands of a great number of new capitalists, small capitalists -- professional men, working men, small entrepreneurs. Individually considered, their savings are small; in the aggregate, large. Hopeful and inexperienced, they have come to the security markets for the first time.

On the other side, the growth of American business has resulted in a corresponding growth in the volume of corporate securities. The financial structure of American corporations has grown exceedingly intricate and complex, and its securities have reflected these conditions. It is simply impossible for the individual investor to make his security analysis by himself, he must seek competent advice.

There has been sales pressure from the distributors of securities. There are fashions in finance, and the sellers of securities are constantly looking for some new style to dangle before the public eye. The investment trust was something new. It provided security dealers with a novel and persuasive appeal.

The great profits of corporations have also been a factor. Investors have been eager to get into common stocks, to share in rising earnings, extra-divi-

ment. Especially important is the fact that much of this new capital is in the hands of a great number of new capitalists, small capitalists -- professional men, working men, small entrepreneurs. Individually considered, their savings are small; in the aggregate, large. Hopeful and inexperienced, they have come to the security markets for the first time.

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The great profits of corporations have also been a factor. Investors have been eager to get into common stocks, to share in rising earnings, extra-divi-

dends, and stock bonuses. Lastly, there has been the greatest stock-market boom of history(January, 1927 to October, 1929). The public rushed to purchase in a market that seemed destined to keep moving upward forever.

AMERICAN TYPES

General

In Great Britain the structure of the investment trust is comparatively simple. As pointed out earlier, the British trusts are organised as joint-stock enterprises under the Companies Acts. They exhibit a simple capitalisation of debentures, preference stock and ordinary stock. American finance shows no such simplicity. There is a bewildering diversity of types. This section does not aim to describe all the variations, but only the outstanding types, especially those which seem to possess elements of permanency.

Classification

The major classification will rest on the relation of the holders of the trust securities to the portfolios whence they derive their income. This basis is adopted because it is the simplest, the most precise, and shows the least overlapping. Other significant classifications may be made on the basis of the scope of

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management, the legal form, and the field of investment operation. But sub-classifications on these bases necessitate a great amount of overlapping, they tend to confuse as much as clarify. However, the elements on which these latter classifications rest are important and will be discussed in connexion with each type that is taken up under the classification adopted.[8]

Outline

The following are the main headings in the classification. Under each heading one or more actual trusts will be described and analysed.

(1) Statutory trusts. -- The portfolio is owned by the trust itself, not directly by the security holders.

(2) Contractual trusts. -- The portfolio is owned directly by the security holders.

(a) Fund type. -- The portfolio is represented as a general fund which is owned in common by the certificate holders.

(b) Unit-share type. -- The portfolio consists of separate units or groups of securities, the exact composition of these units being designated in advance. Certificate holders are entitled to pro rata shares in whatever units their certificates originate.

[8] Cf. Schreiber, H. E. op. cit. p. 161-73. Also, Robinson, L. R. op. cit., p. 31-48; and Thralls, J. Different Types of Investment Trusts, 128 Chronicle 949-50 (February 16, 1929)

The Unit-share type

Because of its simplicity, the unit-share form will be considered first. It is distinctly an American creation. The reasons for its existence seem to have been a desire to secure the advantages of diversification and expert selection while avoiding the dangers of mismanagement inherent in plans which allow for continuous supervision of the investment fund, and to make an appeal to the investor by showing him in advance exactly what he is getting and assuring him that the original selection will not be disturbed. The important divisions of the unit-share type must be made on the basis of management. There is the rigid type which excludes management after the original selection of securities, and the flexible type which allows for a very limited supervision of the portfolio.

The Rigid Type

Diversified Trustee Shares, Series C,[9] is an excellent illustration of the rigid type. The legal basis is, of course, contractual -- a trust agreement. There are three parties to the agreement: the Depositor, the Trustee, and the certificate holders. In this case, the Depositor is the American Trustee Share Corporation. It is the business of this company to set up the trust

[9] See Prospectus distributed by Curtis, Stephenson & Co., Inc., Boston. (Undated)

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portfolio and to sell the participating shares to the public(the certificate holders). The Trustee is the Chatham Phenix National Bank and Trust Company. This institution holds the securities which constitute the portfolio, issues the participating certificates, and distributes the earnings.

The plan of operation is as follows: the Depositor delivers to the Trustee certain blocks or units of specified securities. In this case, every unit must contain five shares of each of the following stocks:

10 Rails	Moody's Rating
Atchison,Topeka & Santa Fe Ry. Co. (The). .	Aa
Canadian Pacific Railway Company.	A
Delaware,Lack. & Western R.R. Co. (The) . .	Aa
Illinois Central Railroad Company	A
Louisville & Nashville Railroad Company . .	Aa
New York Central Railroad Company	A
Pennsylvania Railroad Company (The)	A
Southern Pacific Company.	A
Southern Railway Company.	Baa
Union Pacific Railroad Company.	A
10 Public Utilities	
American Telephone & Telegraph Company. . .	Aa
Columbia Gas & Electric Corporation	Baa
Commonwealth Edison Company	A
Consolidated Gas Company of New York. . . .	A
Consol. Gas, Elec. Lt. & Pwr. Co.Baltimore.	A
Detroit Edison Company (The).	A
North American Company (The).	Baa
Pacific Gas & Electric Company.	Baa
United Gas Improvement Company (The). . . .	A
Western Union Telegraph Company (The) . . .	A

21 Industrials	Moody's Rating
Air Reduction Company, Inc.	A
Allied Chemical & Dye Corporation	A
American Can Company	Baa
American Car & Foundry Company.	Baa
Amer. Radiator & Standard Sanitary Corp.	Baa
Borden Company (The)	A
Du Pont(E.I.) de Nemours & Company, Inc.	A
Eastman Kodak Company (New Jersey).	A
General Electric Company.	Aa
Ingersoll-Rand Company.	A
International Harvester Company	A
National Biscuit Company.	Aa
Otis Elevator Company	A
Procter & Gamble Company (The).	A
Reynolds(R.J.)Tobacco Company	A
Sears, Roebuck & Company.	Baa
Union Carbide & Carbon Corporation.	A
United Fruit Company	A
United States Steel Corporation	A
Westinghouse Electric & Mfg. Company.	A
Woolworth (F. W.) Company	A
9 Oils and Mines	
American Smelting & Refining Company.	Baa
Atlantic Refining Company	A
Kennecott Copper Corporation.	Ba
Prairie Pipe Line Company (The)	A
Royal Dutch Company (New York Shares)	A
Standard Oil Company of California.	A
Standard Oil Company (New Jersey)	Aa
Standard Oil Company of New York	Aa
Texas Corporation (The).	A

For each one of these units so deposited, 4,000 participating shares are issued by the Trustee. Certificates representing various numbers of shares are then sold to the public. Certificates may be issued in denominations of 4,000, 1,000, 800, 500, 100, 50, 25, 10, and 5 shares. The holder of a certificate representing

4,000 shares would have a 100 per cent claim on the securities composing the underlying unit, and his certificate would naturally be the only one issued with respect to that unit. The shares of a unit are usually distributed among numerous certificate holders. The purchaser of a 1,000-share certificate would thus have a ¼-claim upon the unit, and the purchaser of a 100-share certificate would have a 1/40 -claim. Certificates are transferable by delivery.

It is to be emphasised that the certificate holders are the actual owners of the stocks in the unit. Neither the Depositor nor the Trustee has any ownership interest. In fact, the certificate holders may exchange their certificates for the actual stocks held by the Trustee. The number of certificates necessary to make the conversion varies from trust to trust. Certificates aggregating 800 Diversified Trustee Shares, Series C, or a multiple thereof are necessary to effect the exchange.

There is no limit to the number of units that the Depositor company may form. As soon as the shares in one unit have been sold, another identical unit may be created and the process repeated.

The main source of income to the certificate holders is the cash dividends paid on the underlying

stocks. Any stock rights received are sold for cash and the proceeds likewise distributed. Stock dividends are kept and added to the unit in multiples of five, left-over or fractional shares are sold and the cash distributed as dividends. In case the stock dividends should represent unlisted stocks, a sale for cash is also made. At times, the Depositor may offer the certificate holders the privilege of reinvesting their earnings through the purchase of additional shares instead of taking the cash dividends.

No substitutions may be made in the stock of a unit, except as a result of extraordinary events affecting the original stock, such as merger or reorganisation. The element of continuous supervision, so characteristic of the British trusts, is missing. The management is paid for its selective function at the time when the certificates are sold. The price of a share is calculated from day to day by adding together the market values of the underlying stocks. To this amount is added commission fees and accumulated dividends, and lastly, a charge of 6½ per cent of the selling price. This charge includes all compensation to American Trustee Share Corporation, all incidental expenses, and all trustee fees in perpetuity. As indicated above, certificate holders may exchange their shares in proper amounts for the actual

underlying securities, and the entire agreement under which the units are formed and the shares issued may be terminated by either the Depositor or the Trustee at such time as the shares outstanding may be less than 100,000. In case this termination takes place within ten years of the issue of any certificates, the owners of such certificates are returned a proportionate part of the 6½ per cent charge made at the time of purchase.

We have then, a trust that utilises the principle of diversification and repudiates the idea of continuous supervision. It is interesting to note the attitude of the promoting company. "The absence of management as applied to the investment list ensures continuance of a balanced investment, prevents any possibility of speculation, errors of judgment or manipulation, and makes it feasible to offer these Shares on a more economical basis, so far as the investor is concerned, than is the case among other investment trusts."[10]

Whatever one may think of this, a real attempt at diversification has been made. A consolidated balance sheet of the fifty companies whose stocks are deposited against the trust certificates shows clearly what diversification means to the small investor; alone he could never attain such investment strength.

[10] Prospectus (See above, page 46)

BOSTON UNIVERSITY
COLLEGE OF LIBERAL ARTS
LIBRARY

Diversified Trustee Shares, Series C

(Combined Statements of 50 Companies Whose Stocks Are Deposited Against the Issue Of These Shares)

Consolidated Balance Sheet

(As of December 31, 1928)

Assets

Plant and equipment.	$17,549,879,000
Investments.	4,865,450,000
Current assets	5,178,576,000
Special funds and miscellaneous assets	994,114,000
Prepaid expenses and deferred assets .	413,957,000
TOTAL ASSETS	$29,001,976,000

Liabilities

COMMON STOCK	$ 9,776,505,000
Preferred stock.	1,810,236,000
Funded debt.	6,475,158,000
Current liabilities.	1,401,871,000
Reserves and miscellaneous liabilities	2,901,926,000
SURPLUS	6,636,280,000
TOTAL LIABILITIES.	$29,001,976,000

The Flexible Type

This device represents an attempt to retain whatever advantage the rigid type may seem to possess, yet at the same time to introduce the element of continuous supervision. A good example of this compromise is Collateral Trustee Shares of the Investment Trust of New York, Inc.[//] The general organisation of this trust is substantially the same as that of the rigid form just considered. Under a twenty-year trust agreement, the Investment Trust of New York purchases, and deposits with

[//] See Prospectus distributed by New York Shares Corporation, N. Y.

the Chase National Bank, stocks of seventy-five leading corporations, in specific units aggregating 250 shares. For each unit so deposited, 1000 Collateral Trustee Shares, Series A, are issued and sold to the public at a price representing the proportional market-value of the securities in that unit plus a 9% management charge which compensates Investment Trust of New York for its work. The only other expense to the certificate holders is a yearly deduction for trustee services, amounting to about ¼ of 1 per cent of the value of each unit. The certificate holders receive all income from cash dividends and from the sale of rights, warrants, and fractional shares of stock dividends. Holders of 1000 shares may at any time exchange their shares for the actual stocks composing the unit. At the end of the twenty-year trust agreement, all securities will be sold and the proceeds distributed to the shareholders.

The seventy-five securities in the original unit constitute the Primary List. But in addition, there is a Reserve List consisting of twenty-five similar stocks. In the words of the prospectus, "Should any corporation in the Standard Investment Unit show an unsatisfactory change that may result in decreased earnings, then the management may cause the stock of the corporation to be sold. The purpose of the Trust is to sell before its weakened posi-

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tion becomes reflected in the market price. When a stock is sold, the proceeds are reinvested in one of the stocks on the Reserve List. Should any stock advance to a price seemingly beyond its intrinsic worth, that stock may be sold, and an amount not less than the cost of the stock sold, must be reinvested in a stock on the list."[a]

There are two additional features. First, every six months three new stocks may be substituted in the Reserve List, but notice of the proposed substitution must be sent to the stockholders, who will have the right to vote thereon. Secondly, should any stock be sold at a profit, the profit is not distributed in dividends, but is placed in a surplus account to be reinvested for the benefit of the certificate holders.

Nothing would be gained by listing the entire portfolio of Collateral Trustee Shares, but a few typical stocks from each of the lists will show that an attempt is made to buy into companies with good records and prospects, to keep the Reserve List on the same investment level as the Primary List, and to diversify as between industries.

Selections from Primary List

Anaconda Copper Mining Co.
Drug Inc.
General Electric Co.
General Foods Corp.

[a]Prospectus (See above, page 46)

Prospectus (See above, page 46)

International Harvester Co.
Pennsylvania Railroad Co.
Southern California Edison Co.
Standard Oil Co. of New Jersey.
U. S. Steel Corp.
F. W. Woolworth Co.

Selections from Reserve List

Atchison, Topeka & Santa Fe. Ry. Co.
Chrysler Corp.
Detroit Edison Co.
Du Pont de Nemours & Co.
Kennecott Copper Corp.
Loose-Wiles Biscuit Co.
Montgomery Ward & Co, Inc.
U. S. Industrial Alcohol Co.
Western Union Telegraph Co.

The establishment of a reserve list, however, is not the only means of introducing substitution into the unit-share type. A different scheme is made use of by Common Stock Trustee Shares, Series A, of United States Share Corporation.[IV] This is a typical unit-share trust whereby participating shares are issued upon units consisting of not less than one share of common stock in each of a hundred specified companies.

Substitution in the unit can be made if dividends or capital value of a stock are endangered, or if an opportunity arises to secure a capital profit. In order to prevent haphazard or reckless substitution, the following terms must be complied with at all times:

(1) Not more than 3 per cent of the value of a unit may be in the stock of any one company;

[IV] Keane's Manual, p. 530-49

International Harvester Co.
Pennsylvania Railroad Co.
Southern California Edison Co.
Standard Oil Co. of New Jersey.
U. S. Steel Corp.
F. W. Woolworth Co.

Selections from Reserve List

Atchison, Topeka & Santa Fe. Ry. Co.
Chrysler Corp.
Detroit Edison Co.
Du Pont de Nemours & Co.
Kennecott Copper Corp.
Loose-Wiles Biscuit Co.
Montgomery Ward & Co, Inc.
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(1) Not more than 3 per cent of the value of a unit may be in the stock of any one company;

[1] Keane's Manual, p. 530-42

(2) No stock shall be acquired for substitution to which Moody gives a rating lower than B;

(3) The total investment of the unit must always show: (a) not more than 10 per cent in stock rated lower than Ba, (b) not more than 50 per cent in stocks rated lower than Baa, (c) not less than 20 per cent in stocks with a rating of A or better, and (d) not more than 12 per cent in any one industry except railroads and public utilities, where the limit for each is 20 per cent;

(4) No stock shall be acquired for substitution which has not paid a dividend within six months prior to the time of purchase, and which is not listed on the Stock Exchange of New York, Boston or Chicago.

Fund Type

The fund type is similar to the unit-share type in that the certificate holders have a direct ownership interest in the portfolio. But there are important differences. The certificates of the unit-share type represent a claim on a specific block of securities whose precise nature is defined beforehand. The certificates of the fund type represent proportional claims upon a general fund held by a trustee. The fund consists of cash or securities, or both. The securities in the fund must conform to investment standards set forth in the

original trust indenture, but these securities are not specifically designated as in the case of the unit-share trust. The factor of continuous management is usually present in the fund type, the Depositor corporation having certain defined powers of changing the composition of the portfolio. This type more nearly approximates the British. But whereas in the British type, the stockholders own the company; in the American fund type, the certificate holders own the fund directly and the management company provides its services under contract, the actual cash and securities constituting the fund remaining constantly in the hands of a trustee.

Investment Managers Company, Trust Fund A,[13] will serve to illustrate this form of investment trust. The company itself is a joint-stock association formed in 1924 under the laws of the State of New York. The function of the company is to manage investment funds in behalf of the holders of certificates representing shares of beneficial interest in such funds. In 1927 Trust Fund A was created.

For managing the fund, Investment Managers Company is entitled to a triple compensation:

(1) 1 per cent of the face value of the certificates at the time of issue, such charge to be paid by the certificate purchasers;

[13] Keane's Manual, p. 269-84

original trust indenture, but these securities are not specifically designated as in the case of the unit-share trust. The factor of continuous management is usually present in the fund type. the Depositor corporation having certain defined powers of changing the composition of the portfolio. This type more nearly approximates the British. But whereas in the British type, the stockholders own the company; in the American fund type, the certificate holders own the fund directly and the management company provides its services under contract, the actual cash and securities constituting the fund remaining constantly in the hands of a trustee.

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For managing the fund, Investment Managers Company is entitled to a triple compensation:

(1) 1 per cent of the face value of the certificates at the time of issue, such charge to be paid by the certificate purchasers;

[1] Keane's Manual, p. 265-64

(2) 1/8 of 1 percent quarterly on the actual value of the investment fund on the last day of each quarter;

(3) 1 per cent of the actual value of the certificates at such time as they may be redeemed, except when redemption takes place at the option of the company.

Each certificate holder is the creator of a separate revocable trust that is evidenced by his certificate. This certificate also constitutes a contract between the certificate holder, Investment Managers Company, and the Trustee, Central Union Trust Company, whereby the managing company undertakes to supervise the fund. In this contract are certain important stipulations:

(1) Out of the net income derived from the fund, the certificate holder is entitled to regular quarterly dividends amounting to 5 per cent per annum;

(2) At the end of each year, the certificate holder is entitled to an additional distribution;

(3) The certificate holder may at any time redeem his certificate and receive its actual value in cash or in proportional amounts of the underlying securities. The manner of payment is at the option of the company;

(4) Certificates are not transferable, but the right of redemption may be assigned;

(5) Subscriptions to the fund are to be made in multiples of $1000, the minimum certificate being for $10,000.

Under the trust agreement, Investment Managers Company has absolute control and management of the fund, subject to the following restrictions:

(1) To the extent that the fund is invested in common stocks, it shall not be distributed among more than thirty corporations;

(2) Securities purchased must be regularly listed on the New York Stock Exchange, and must have been traded in during each of the twelve months prior to the date of purchase for the fund;

(3) Not more than 20 per cent of the value of the outstanding certificates shall be invested within a single industry;

(4) No investment shall represent more than 10 per cent of the voting stock of any corporation;

(5) No investment shall be made in any corporation if the total outstanding capital stock of that corporation shall have a market value of less than $20,000,000;

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(6) No investment shall be made in the securities of any corporation if the market-value of such securities as would be purchased be more than 5 per cent of the value of outstanding trust certificates;

(7) The company may invest any portion of the fund in tax-exempt securities, obligations of the United States, and in call loans, provided the latter are secured by stocks or bonds with a market-value 20 per cent in excess of the face of the loans.

In the distribution of earnings, it has been the policy of the company, after paying the regular 5 per cent charge, to declare an extra distribution equal to 12½ per cent of the income earned in excess of this charge. The remainder is reinvested and thereby enhances the value of the certificates. Extra dividends(on the face value of outstanding certificates)have been paid as follows:

1925	0.49%
1926	0.57%
1927	0.84%
1928	0.65%

The calculation of the face value of certificates is an interesting procedure. The face value of outstanding certificates represents the market-value of the assets applicable to those certificates at the time of purchase or issue. Appreciation in the value of the

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fund tends to make the net value of the certificate increasingly greater than the original face value. In December 1928, there were outstanding against Fund A, 1,255,461 shares with a total face value(value at time of issue)of $15,286,700. This represents a face value of $1217.61 per 100 shares. But if undistributed income of $822,777.01 and unrealised profit(increases in market-value over cost)of $1,380,229.32 are added to the total face value, there is a grand total of $17,489,706.33. This gives a net value of $1,393.09 per 100 shares, and for a new purchaser, this last amount would be the face value which he would have to pay for 100 new shares. In December 1927 the net value per 100 shares was $1,244.53. A holder of 100 shares at the end of 1927 would thus be able to sell his shares a year later at a profit of $158.56.

A condensed income statement will show sources and also reveal the extent of managerial compensation, as well as the process of taking profits through certificate redemption.

For the Year 1929

Income:		
Interest	$ 575,132.60	
Dividends	254,710.00	
Profit on sales	1,322,482.52	$2,152,325.12
Deduct: Management compensation		82,963.40
		$2,069,361.72

fund tends to make the net value of the certificate increasingly greater than the original face value. In December 1928, there were outstanding against Fund A, 1,285,461 shares with a total face value(value at time of issue)of $15,286,700. This represents a face value of $1217.81 per 100 shares. But if undistributed income of $822,777.01 and unrealized profit(increases in market-value over cost)of $1,380,229.82 are added to the total face value, there is a grand total of $17,489,708.83. This gives a net value of $1,393.09 per 100 shares, and for a new purchaser, this last amount would be the face value which he would have to pay for 100 new shares. In December 1927 the net value per 100 shares was $1,244.53. A holder of 100 shares at the end of 1927 would thus be able to sell his shares a year later at a profit of $148.56.

A condensed income statement will show sources and also reveal the extent of managerial compensation, as well as the process of taking profits through certificate redemption.

For the Year 1928

Income:		
Interest	$ 875,152.60	
Dividends	284,710.00	
Profit on sales	1,382,486.52	$2,542,349.12
Deduct: Management compensation		82,982.40
		$2,459,366.72

(Forward)			$2,069,361.72
Deduct:	Regular 5% dividend	$725,430.20	
	Extra dividend	94,500.00	819,930.20
			$1,249,431.52
Add:	Undistributed income at beginning of period		862,586.58
			$2,112,318.10
Deduct:	Accrued profit paid to certificate holders on redemption		1,289,541.09*
Undivided Income			$ 822,777.01

*Over $700,000 of this amount reinvested in new shares

Calculated in terms of percentage of face value of certificates outstanding, the net income from Fund A has been as follows:

1925	9.00 %
1926	9.21
1927	12.18
1928	14.26

The Statutory Type

Under this heading come investment trusts that are formed under State laws of incorporation or as Massachusetts trusts. The statutory type is by far the most important one in American investment trust finance. In his study of February, 1929, Robinson found that out of 156 American investment trusts, 136 were of the statutory type.[14] Within the statutory type, the corporate

[14] Robinson, L. R., op. cit., p. 546-8

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Robinson, L. R., op. cit., p. 546-8

form completely overshadows the Massachusetts trusts. These latter can be disposed of briefly.

Massachusetts Trusts

These associations are found practically only in the State of Massachusetts. They arose from the fact that corporations in that state could not hold real estate for investment purposes. In order to get around the law, title to real estate was vested in a group of trustees, whose powers in respect to the administration of the property were defined in the trust agreement. The trustees issued certificates of beneficial interest in the trust property. These certificates were sold to the public. These certificates carried limited liability and were transferable. They are bought and sold in the same manner as corporate stocks. But the shares have no voice in the management, otherwise the association would become a partnership. Recent statutes in Massachusetts have placed these trusts in practically the same legal position as ordinary corporations.[15]

However, a number of investment trusts formed in Massachusetts have found this device useful. Some of these trusts issue only a single kind of share, others exhibit a capitalisation similar to that of a corporation.

Massachusetts Investors Trust[16] is an example

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of a trust issuing but one class of shares. The management is entrusted entirely to four trustees who receive 6 per cent of the annual income, out of which all ordinary expenses of operation are met. No salaries are paid. The rest of the income goes to the shareholders. Differing from the contractual types, the shareholders cannot demand a direct redemption of their shares in cash or in securities. They may either sell their shares in the open-market, or, if a satisfactory price cannot be obtained, the trust must purchase the shares at a price equal to their net asset value less 1 per cent. This particular trust surrounds the trustees with no restrictions; they have complete freedom in the management of the portfolio.

Century Shares Trust,[17] sponsored by Brown Brothers and Company, is organised in practically the same way. The chief point of difference is in the capitalisation. There are two types of shares, equal in number, the Participating and the Ordinary. Brown Brothers purchases these shares from the trustees in units of two (one Participating, one Ordinary)at a price determined by the liquidation value of outstanding shares. Brown Brothers retains the Ordinary shares, the Participating shares go to the public. Each Participating share is

[17] See Prospectus distributed by Brown Brothers & Co., Boston.

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shares go to the public. Each Participating share is

See prospectus distributed by Brown Brothers & Co.,
Boston.

entitled to a yearly non-cumulative dividend of $2, and $50 in case of liquidation. Any additional distributions of earnings or assets are divided 85 per cent to the Participating shares and 15 per cent to the Ordinary. In this trust no management fee is paid to the trustees, and the portfolio is restricted to insurance and bank stocks.

Corporations

Last of all will be considered the investment trust organised as an ordinary domestic corporation. This type most clearly approximates the British form, and is by far the most important type in the United States, both numerically and in total amount of invested capital. Investors Equity Company[18] is typical. This company was incorporated in Delaware in May, 1927. Its chief characteristics are lack of restraint upon management, complicated capitalisation, and world-wide portfolio diversified between bonds and stocks. The charter and by-laws contain nothing relating to investment policies and standards, all responsibility lies with the management. The plan of capitalisation is somewhat complex, but will be considered in all its detail, as it illustrates a characteristic of incorporated investment trusts in this country. The capital set-up is as follows:

[18] Keane's Manual, p. 296,307

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[1] Keane's Manual, p. 296,307

	Authorised	Outstanding
No Par Common	620,000	232,920
No Par Preferred(cum.)	120,000	30,000A, $6
		31,000B, 5.50
Debentures, 5%	$20,000,000	$5,000,000A, 1947
		4,650,000B, 1948

Preferred A carries $6 cumulative dividends, is preferred as to assets at $110 per share, and may be redeemed, in whole or in part, at $110 on sixty-day notice. Every share of Preferred A carries a non-detachable warrant which entitles the holder to receive, without cost, one share of common stock upon the initial payment of a dividend upon the common. Preferred A may also be exchanged for common on the basis of three shares of common for one of Preferred A plus the attached warrant.

Preferred B is a similar stock. The rate per annum is $5.50. This stock is cumulative, is entitled to $105 a share in case of liquidation, and is redeemable at $105. Each share of Preferred B carries a warrant entitling the holder to subscribe for one share of common stock at $30 per share up to April 1931, at $40 from 1931 to 1934, and at $50 from 1934 to 1938. Three shares of common will be exchanged for one share of Preferred B, plus warrant, plus a cash payment of $30; or two shares of common for one share of Preferred B, subsequent to the exercise of the warrant.

Debenture 5's, Series A of 1947, are callable

	Authorized	Outstanding
No Par Common	650,000	282,930
No Par Preferred(cum.)	120,000	30,000
		21,000
Debentures, 5%	$20,000,000	$5,000,000
		4,650,000

Preferred A carries $6 cumulative dividends, is preferred as to assets at $110 per share, and may be redeemed, in whole or in part, at $110 on sixty-day notice. Every share of Preferred A carries a non-detachable warrant which entitles the holder to receive, without cost, one share of common stock upon the initial payment of a dividend upon the common. Preferred A may also be exchanged for common on the basis of three shares of common for one of Preferred A plus the attached warrant.

Preferred B is a similar stock. The rate per annum is $5.50. This stock is cumulative, is entitled to $105 a share in case of liquidation, and is redeemable at $106. Each share of Preferred B carries a warrant entitling the holder to subscribe for one share of common stock at $50 per share up to April 1931, at $40 from 1931 to 1934, and at $30 from 1934 to 1938. Three shares of common will be exchanged for one share of Preferred B, plus warrant, plus a cash payment of $30; or two shares of common for one share of Preferred B, subsequent to the exercise of the warrant.

Debenture 5's, Series A of 1947, are callable

in whole or in part, on notice of thirty days, at 103 up to June 1930, thereafter at 100. As long as any debentures are outstanding, the company agrees not to contract any funded debt unless the net assets of the company are at least 140 per cent of such debt. If at any time the net assets fall below 110 per cent of the funded debt, the company will redeem all outstanding debentures on the next semi-annual interest date. Debentures A carry non-detachable warrants entitling the holders to secure, without cost, five shares of common stock at the time of the payment of the first dividend on the common stock.

Series B is identical with Series A, except that the attached warrant entitles the holder to subscribe for five shares of common stock at $30 per share, such warrant being exercisable up to date of maturity or prior redemption.

Although no special restrictions bind the management, Investors Equity Company has followed the general policy of investing throughout the world, and in both stocks and bonds. Such policy is consonant with the British tradition. In November, 1928, the portfolio contained the securities of 264 companies or political entities. The detail is as follows:

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Domestic Common Stocks	34
Domestic Preferred Stocks	91
Domestic Bonds	41
Domestic Short Term Obligations	3
Foreign Stocks	13
Foreign Dollar Bonds	82
Total	264

The American holdings are quite similar to those found in the unit-share portfolios shown above. A few selections from the foreign list will show the general nature of commitments abroad.

Stocks

1,000	Investment Trust Associates, Ltd., Ordinary
200	Swiss American Electric Co., $6 Preferred
RM 48,000	Deutsch Bank Capital Stock
GM 85,000	German Railways, 7% Preferred

Bonds

$ 25,000	Government of Argentina, 6's of 1961
50,000	City of Vienna, 6's of 1952
100,000	Kingdom of Belgium, 7's of 1956
50,000	Republic of Finland, 6½'s of 1956
100,000	Paris Lyons Mediterranean R. R. Co. 6's of 1958
25,000	City of Berlin, 6½'s of 1950
50,000	North German Lloyd, 6's of 1947
50,000	Kingdom of Italy, 7's of 1952
25,000	Nippon Electric Power Co., Ltd., 6's of 1953
50,000	City of Tokio, 5½'s of 1961
50,000	Norwegian Hydro-Electric Nitrogen Corp., 5½'s of 1957

Another incorporated trust that follows the policy of international diversification is British Type Investors, Inc.[19] This company offers an unusually complete analysis of its portfolio, and their statistics of September 30, 1929 are offered as an example of thorough-

[19] Analysis distributed by Glover & Co., Boston.

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Foreign Dollar Bonds	82
Total	264

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Stocks

1,000 Investment Trust Associates, Ltd., Ordinary
200 Swiss American Electric Co., 5% Preferred
RM 48,000 Deutsch Bank Capital Stock
DM 85,000 German Railways, 7% Preferred

Bonds

$ 25,000 Government of Argentina, 8's of 1961
50,000 City of Vienna, 6's of 1952
100,000 Kingdom of Belgium, 7's of 1956
50,000 Republic of Finland, 8½'s of 1956
100,000 Paris Lyons Mediterranean R. R. Co. 6's of 1956
25,000 City of Berlin, 6½'s of 1950
50,000 North German Lloyd, 6's of 1947
50,000 Kingdom of Italy, 7's of 1952
25,000 Nippon Electric Power Co., Ltd., 6's of 1953
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Another incorporated trust that follows the policy of international diversification is British Type Investors, Inc. This company offers an unusually complete analysis of its portfolio, and their statistics of September 30, 1929 are offered as an example of thorough-

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going diversification on an international basis.

United States		
Banks	6.07 %	
Chain Stores	1.11	
Chemicals	2.78	
Equipment	.96	
Foods	2.92	
Industrial and Manufacturing	9.00	
Insurance	8.15	
Investment Trusts	4.69	
Miscellaneous	4.82	
Motors	.47	
Non Ferrous Metals	4.41	
Oil	6.03	
Public Utilities	2.18	
Railroads	7.34	
Rubber	.09	
Sugar	.46	
Textiles	.09	
Tobacco	1.37	
Total United States		62.94 %
Asia		
Japan	1.84 %	
Total Asia		1.84 %
Australia	.30 %	.30%
Europe		
Austria	1.45 %	
Belgium	.28	
Bulgaria	.43	
Czechoslovakia	.14	
Denmark	.53	
Esthonia	.10	
Finland	2.69	
France	.12	
Germany	7.95	
Hungary	1.02	
Italy	3.75	
Norway	.29	
Poland	.14	
Roumania	.11	
Russia	.22	
Serbia	.38	
Total Europe		19.63 %

going diversification on an international basis.

United States

Banks	6.07 %
Chain Stores	1.11
Chemicals	2.78
Equipment	.86
Foods	2.92
Industrial and Manufacturing	9.00
Insurance	8.15
Investment Trusts	4.89
Miscellaneous	4.82
Motors	.47
Non Ferrous Metals	4.41
Oil	8.03
Public Utilities	2.18
Railroads	7.34
Rubber	.09
Sugar	.45
Textiles	.09
Tobacco	1.37
Total United States	62.84 %

Asia

Japan	1.84 %
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Australia .30 % .30%

Europe

Austria	1.45 %
Belgium	.28
Bulgaria	.43
Czechoslovakia	.14
Denmark	.53
Estonia	.10
Finland	2.59
France	.12
Germany	7.93
Hungary	1.02
Italy	3.75
Norway	.29
Poland	.14
Roumania	.11
Russia	.22
Serbia	.28
Total Europe	19.83 %

Latin America

Argentina	1.84 %
Bolivia	.16
Brazil	5.69
Chile	3.92
Colombia	1.19
Costa Rica	.50
Cuba	.07
Dominican Republic	.06
Ecuador	.01
Peru	1.62
Uruguay	.23
Total Latin America	15.29%
Total Portfolio	100.00%

The complete freedom of management found in Investors Equity Company is not entirely characteristic of American practice. It is quite usual to find certain limitations upon management explicitly stated in charters and by-laws. The investment restrictions which govern the policies of Investment Company of America[20] are worth quoting in full. They offer an excellent example of the degree to which restrictions in this country are sometimes pushed in the attempt to check reckless management beforehand.

No investment shall be made in:

"(1) Real estate.

(2) Any security involving promotion or business management on the part of the trust.

(3) Any security involving the risk attendant upon a new and unproved enterprise.

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[20] Keane's Manual, p. 709-15

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ment authority about which reliable information is not available as respect history, management, assets and income.

(5) Securities which have not been passed upon by the Advisory Board and placed by the Board on the 'Eligible List.'

(6) Shares of the Trust except Preferred Shares for retirement and cancellation.

(7) Any security which subjects the Trust to unlimited liability.

Concerning diversification:

(1) Not more than 5% may be invested in the securities of any one corporation.

(2) Not more than 40% may be invested in railroads and steamship lines.

(3) Not more than 40% may be invested in public utilities.

(4) Not more than 40% may be invested in stocks of banks, trust companies and insurance companies.

(5) Not more than 20% may be invested in any other line of industry.

(6) Not more than 40% may be invested in the British Empire.

(7) Not more than 10% may be invested in any subdivision of the British Empire other than the British Isles or the Dominion of Canada.

(8) Not more than 20% may be invested in any foreign country other than the British Empire.

(9) Not more than one-half of the percentage permitted to be invested in any foreign country may be invested in any securities other than securities issued by the government or a political subdivision thereof."

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force a balanced diversification. The usual run of restrictions are not quite so stringent.

All the corporate investment trusts so far mentioned have attempted to secure a world-wide diversification, but there are many that do not. A large number of the American Trusts confine themselves to the domestic field and many specialise in the securities of a single industry. Some deal in bonds, excluding stocks, and vice versa. The names of a few companies speak for themselves: Airstocks, Inc.; Bond Investment Trust of America; Chain Store Stocks, Inc.; Electric Investors, Inc; Oilstocks, Ltd.; Public Utility Investing Corporation; Insuranshares Corporation.

The Trading Company

It was pointed out at the very beginning, that investment must be distinguished from speculation, and that the title of investment trust properly belongs to those organisations engaged in the former activity. Along with the genuine investment trust, there has grown up a device known as the trading company. It is purely a speculative scheme. The participators toss their money into a blind pool, and the operators of the pool attempt to make a speculative profit. The operators have complete control of the fund. They make no financial reports and publish no list of holdings. The participants

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are ignorant of all proceedings; they simply sit still and wait for their quarterly checks. The trading company is not to be condemned as such. For the person who must speculate, the trading company affords opportunities for greater success than he would be likely to achieve by his own efforts. But there is a danger that such speculative enterprises may be confused with investment trusts. The person who wants to secure the advantages of sound investment management should make sure that he gets them, and the person who places his money in a trading company should not fool himself into thinking that he is enjoying the benefits that a genuine investment trust offers.

INVESTMENT TRUST INTEGRATION

It might be inferred, from what has gone before, that each individual trust had its own separate and independent management, that each trust made its own security analyses and relied on the judgment of its own executives. This is decidedly not the case. Although there are a considerable number of trusts having no affiliation with other organisations, a great many more secure part or all of their investment management from other companies especially equipped for the task of investment analysis and counsel. The relationships between

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the individual trusts and the management companies are very close and exceedingly complex. Usually the company which supplies the investment technique has a large common stock interest, frequently a controlling one, in the companies to which it furnishes service. The management company thus performs the dual function of investment specialist and holding company. In addition, it is quite likely that the holding and managing company has a diversified portfolio of its own, exclusive of its holdings in subsidiary or affiliated companies.

There are a number of factors which are conducive to the development of investment trust groups centering around some single management company:[vi]

(1) A trust sponsored by a strong management organisation is usually better able to raise capital than a trust which enters the field alone.

(2) It is essential that the management organisation of a new trust begin to function immediately. The trust that is affiliated with an already existing group enjoys experienced management from the start.

(3) Economy in management costs is an important factor in trust earnings. Good investment organisations are costly and will be profitable only when their activities are applied to a very large investment

[vi] Cf. Robinson, L. R. op. cit., 467-8

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fund. In a general way, investment management obeys the law of decreasing costs. The investment of a large fund can be attended to at a cost not very much greater than would be required to administer a very much smaller portfolio. A trust that is linked with a large investment organisation gets a large part of its investment service at nominal cost.

American Founders Corporation

A simple exposition of concentration and interlocking in the investment trust field is impossible. The only feasible procedure is to analyse some special group. The one selected is known as the American Founders Group. It is the largest and most important in this country. It is a pioneer organisation, and one of the most successful.

As a recent prospectus states, "American Founders Corporation was organised under the laws of Maryland in 1928 as successor to American Founders Trust, a voluntary trust organised under the laws of Massachusetts in January, 1922."[77]

There are four major divisions to the activities of this company:

(1) A holding company. -- American Founders Corporation holds the controlling interest in Interna-

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tional Securities Corporation of America, Second International Securities Corporation, United States & British International Company, Ltd., and American & General Securities Corporation. These four companies are regular investment trusts of the general management type, offering their debentures and part of their stock to the public. The controlling interest is also held in Founders General Corporation, a company which specialises in the distribution of investment trust securities; and in American Founders Office Building, Inc., the home office of the parent corporation and a real estate venture.

The extent of control in these subsidiaries is revealed by the following figures:[v3]

(a) Preferred stock of:

International Securities Corporation	68.27 %
Second International Securities Corp.	
First Preferred	80.33
Second Preferred	100.00
United States & British International	75.78
American & General Securities Corp.	91.67
Founders General Corporation	100.00

(b) Class A Common stock of:

International Securities Corporation	83.82 %
Second International Securities Corp.	86.16
United States & British International	89.93
American & General Securities Corp.	80.80
Founders General Corporation	100.00

[v3] Annual Statement for 1929 130 Chronicle 639-48, January 25, 1930.

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International Securities Corporation	83.82 %
Second International Securities Corp.	88.18
United States & British International	89.93
American & General Securities Corp.	80.80
Founders General Corporation	100.00

(c) Class B Common stock of:

International Securities Corporation	80.06 %
Second International Securities Corp.	83.33
United States & British International	68.73
American & General Securities Corp.	80.10
Founders General Corporation	100.00

(d) Common stock of:

American Founders Office Building	100.00 %

(2) An investment service company. -- The portfolios of the four subsidiary companies are under the supervision of the executives of these companies, but the executives rely on the analyses and advice of American Founders in making their selections. For this service the parent company receives a regular fee. International Securities pays an annual fee of 4 per cent of gross earnings after taxes. The other three trusts pay an annual charge of ½ of 1 per cent of their average resources. In addition, American Founders supplies investment service to the United National Corporation of Seattle which is the central organisation for a number of Pacific Coast investment trusts. United National pays American Founders 33 1/3 per cent of the service fees which the former receives from its affiliated companies.

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securities, representing productive enterprises throughout the world.

(4) A financing company. -- Through its subsidiary, Founders General Corporation, the parent company is prepared to engage in the underwriting and general distribution of the securities of other investment trusts.

Thus it is seen that American Founders Corporation has four sources of income: (1) from the stock holdings in subsidiaries, (2) from its own portfolio, (3) from its investment service fees, and (4) from its financing operations.

United Founders

Before examining the activities of American Founders in more detail, another organisation, United Founders Corporation, will be described. This company stands in a peculiar relation to American Founders, and an outline of its functions is necessary for a complete picture of the group.

United Founders Corporation was organised in February, 1929. In the words of President L.H. Seagrave (also president of American Founders), this company has three major purposes:[24]

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eral management type,

(2) To acquire minority or controlling interests in investment companies, with the collateral advantage of bringing investment service contracts to American Founders Corporation, and

(3) To acquire a substantial minority control in the common stock of American Founders Corporation so as to insure continuity of management.

In the first place, then, United Founders plans to make large commitments to single enterprises and industries. These holdings are regarded as permanent and are largely confined to the fields of banking, insurance, public utilities, and railroads. A few examples will show the general nature of these investments. Approximately a 25 per cent interest is held in United States Electric Power Corporation, one of the largest public utility holding companies in the United States. Large blocks of stock are held in Public Utility Holding Corporation of America and in United National Corporation. The latter company has controlling interests in investment trusts, investment banks, real estate enterprises, and insurance companies in the Pacific Northwest. This corporation gets investment service for the management of its trusts from American Founders Corporation.

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Lastly, United Founders is linked with American Founders by virtue of a one-fourth ownership in the latter.

Figures showing the distribution of investments in the portfolio of United Founders will give perhaps the best idea of the nature of its activities.(Percentage figures refer to total assets.)[25]

American Founders Corporation. . .	42.674 %
Transportation	3.036
Public Utilities	24.349
Industrials	4.967
Banks	1.594
Investment Organisations	16.635
Financing Companies.	.176
	93.431
Cash	6.569
	100.000 %

Sources and size of income for the year 1929 are as follows:

Interest & Dividends	$ 8,145,847
Profits on Sales	7,406,092
Miscellaneous	31,250

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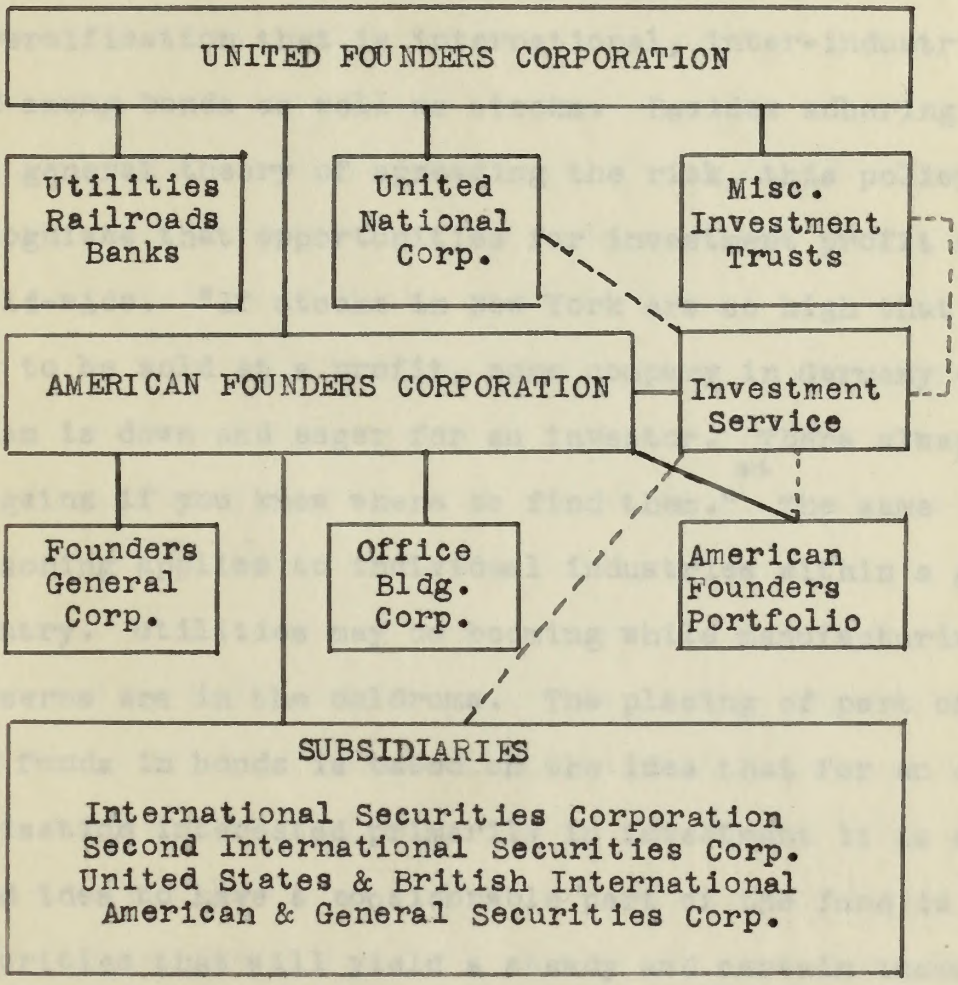

Administration

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also recognises the cyclical factor, "at times of low interest rates bonds and other fixed income-bearing securities are definitely strong in market price."[27]

(3) Maintenance of strong cash position. -- The investment markets are extremely sensitive, high rates in various parts of the world quickly attract funds, and security prices are brought back into equilibrium. In order to take immediate advantage of low security prices whenever and wherever they may appear, it is obviously wise to have a sufficiency of fluid funds.

(4) Active supervision of the portfolio. -- While American Founders emphatically is not a trading company handling funds in the manner of the individual speculator, it does pursue the policy of selling from time to time in order to take advantage of investment bargains and to avoid deterioration in certain securities. When the management purchases a security it does so because that security has true investment value. The securities purchased are those of indubitably strong companies with good prospects for the future. But such purchase by no means implies permanent retention in the portfolio. The management does not hesitate to sell for reasons just mentioned. This is not speculation, it is merely financial prudence.

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A few figures from the consolidated earnings statements as of November 30, 1929 will throw more light on the subject than many pages of explanation. The major items of income show the great size of the organisation and reveal the tremendous importance of profits in investment trust earnings.[78]

Interest and dividends	$ 13,919,790
Profit on sales	17,609,949
Service fees	83,290
Syndicate & other income	122,199
	$ 31,745,228

The chief asset figures from the balance sheets show the strong cash position and give some idea of the relative prominence of the different subsidiaries.[79]

Cash and call loans	$ 10,996,515
General portfolio	36,518,050
International Securities. . . .	33,728,697
Second International.	14,300,791
U.S. & British International. .	9,480,882
American & General.	14,685,882
Founders General	7,575,000
American Founders Building. . .	251,471
	$127,537,288

Since 1921 the average rate of gross earnings of all five companies has been in excess of 12 per cent on the average capital funds. This excellent showing must be attributed to efficient management which has not only been able to make large profits, but has shown a constantly declining ratio of costs to income.

American Founders and each of its subsidiaries

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are under some restrictions as to management. These restrictions are contained in the indentures under which the debentures of the companies are issued. In order to sell these obligations at a low rate it is necessary that they be accorded all reasonable protection. The investment covenants of International Securities Corporation is representative of the entire group. The items are as follows:[30]

"(1) The Corporation shall not invest its funds in securities of any corporation or organisation unless such corporation or organisation or its predecessor, or the guarantor of any guaranteed securities, shall have been established for at least four years prior to such investment.

(2) Not more than 55% of the corporation's funds shall be invested at any one time in securities originating . . . . in Great Britain and not more than 35% shall be invested at any one time in securities originating in any other one nation or country except the United States of America.

(3) Not more than 10% of the Corporation's funds shall be invested in securities representing any one distinct class of business or industry.

(4) Not more than 1¾% of the Corporation's funds shall be invested in securities of any one obligor or issuer except governmental obligations and not more than 5% thereof shall be invested in the securities of any one government except either the United States of America or Great Britain.

(5) The Corporation's funds shall be invested in at least 400 different securities.

(6) The Corporation shall not engage in any promotion, business management or business financing and will confine its operations to the investment and reinvestment of its resources in marketable securities.

[30] Robinson, L. R. op. cit., p. 177-8

are under some restrictions as to management. These restrictions are contained in the indentures under which the debentures of the companies are issued. In order to sell these obligations at a low rate it is necessary that they be accorded all reasonable protection. The investment covenants of International Securities Corporation is representative of the entire group. The items are as follows:[30]

"(1) The Corporation shall not invest its funds in securities of any corporation or organization unless such corporation or organization or its predecessor or the guarantor of any guaranteed securities, shall have been established for at least four years prior to such investment.

(2) Not more than 5% of the corporation's funds shall be invested at any one time in securities originating . . . . in Great Britain and not more than 5% shall be invested at any one time in securities originating in any other one nation or country except the United States of America.

(3) Not more than 10% of the Corporation's funds shall be invested in securities representing any one distinct class of business or industry.

(4) Not more than 1½% of the Corporation's funds shall be invested in securities of any one obligor or issuer except governmental obligations and not more than 5% thereof shall be invested in the securities of any one government except either the United States of America or Great Britain.

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The technique of investment is interesting. The investment organisation is concentrated at the home office in New York. This organisation is made up of three groups: (1) the economists, (2) the analysts, and (3) the investment executives. The economists attempt to locate profitable investment areas in all parts of the world through the study of basic conditions in trade, industry, and finance. The analysts are split into two groups: the single-industry men who specialise in separate fields such as banks, utilities, industrials, and rails; and a second group that concentrates on the securities of separate countries. These men are drawn from the countries concerned, and there are representatives in London and Berlin. Through the joint efforts of the economists and the analysts, recommendations for purchase and sale are made which go to the investment executives, final decision resting with the Investment Committee. Upon approval by this committee recommendations are sent to the executive committee of American Founders and to the executive committees of the associated companies. It is entirely up to those committees as to the action that will be taken on the recommendations. If approvals are given for purchase or sale, the investment department of American Founders is notified and this department ex-

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ecutes the order in the market. The executive committee of American Founders makes its own independent decisions regarding its own portfolio.

A few more statistics will complete this study of the American Founders group. The following table shows the international distribution that has been attained:[31]

United States		42.373 %
British Commonwealth of Nations		8.694
Central and South America		3.395
Continental Europe:		
Northern Europe	2.588	
Central Europe	25.570	
Eastern Europe	2.060	
Southern Europe	2.787	
Western Europe	1.191	34.196
Japan and Asiatic Countries		2.564
		91.222
Cash		8.778
		100. %

The next table shows the division among stocks and bonds; and among types of enterprise.[32]

Bonds

Government	14.765 %
Transportation	.441
Public Utilities	4.595
Industrials	5.543
Mortgage and other Bonds	5.788
Investment Organisations	.142
Financial Companies	.828
	32.092 %

[31] Annual Statement, 1929, op. cit.
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Preferred Stocks

Transportation	.449 %
Public utilities	.692
Industrials	.585
Investment Organisations	3.139
Financial Companies	.874
	5.739 %

Common Stocks

Transportation	3.434
Public Utilities	13.786
Industrials	16.076
Banks and Insurance Companies	7.990
Investment Organisations	11.287
Finance Companies	.818
	53.391 %
Cash	8.728
	100. %

It is a well established principle of investment that in as many cases as possible foreign securities should be payable in American gold dollars. This is especially desirable when the countries in which the securities originate have an unsatisfactory record from the standpoint of monetary stability. In instances where it is impossible to secure payment in American gold dollars, effort should be made to have the securities payable in the currence of some foreign country whose monetary structure is unquestioned. The following figures show the chief currencies in which principal and dividends of American Founders' holdings are payable:[33]

U. S. Dollars	67.694 %
Pounds Sterling	7.054
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Japanese Yen	1.108 %
Austrian Schillings. . . .	1.675
Colombian Pesos.	1.342
Hungarian Pengos	1.574
Dutch Guilders	.997
Swedish Kronen	.216
Norwegian Kronen	.583
Italian Lires.	.083
French Francs.	.863
Belgian Francs	.150
Polish Zloties	.256
Other Currencies	2.446
	100. %

It was suggested above that, with an increase in the fund which an investment organisation handles, there is usually a lowering of proportionate costs of management. The American Founders group has grown rapidly in the past three years, and the ratios of expenses to income have been as follows:[34]

1927	17.20%
1928	15.90%
1929	9.05%

The preceeding discussion shows clearly that investment trusts in United States have attained size and strength, and that management technique has been developed to a point where sizeable investment profits can be secured without departure from sound principles.

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MISCELLANEOUS ASPECTS

American investment trusts are still in the formative period. The preceding analyses give some indication of the diversity of practices and policies now prevailing. But a few general trends may be discerned, and there are a number of characteristics which stand out in contrast with the British tradition.

The General Trend

Although for a while the contractual forms with little or no supervision were predominant(and they are still important), the trusts of the statutory type, largely corporate in form, conferring broad powers to management and attaining a fairly widespread diversification, have overshadowed the former. The contractual types experienced quite a growth in 1927 - 28, but in the next two years the statutory types gained rapidly. These last now constitute over 80 per cent of the trusts formed in this country.

Specific Characteristics

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Specific Characteristics

(1) Establishment and control of trusts by banks and investment banking houses. -- The organization

of investment trusts opened up new possibilities for profit to these institutions and they were not slow to take advantage. Investment trusts with the backing of powerful established houses made an immediate appeal to the public who have great faith in the soundness and integrity of these institutions. It has been estimated that 60 per cent of the investment trusts in this country are sponsored or controlled by banks or bankers.[35] There is, however, an element of danger in this procedure. It is possible that some investment trusts may be too closely linked with parent investment houses and come to serve as a dumping ground for indigestible securities or that large blocks of issues underwritten or distributed by the parent houses may clog the portfolios to the detriment of diversification.

(2) Growth of large investment trust groups or "families" through the holding company device and interlocking directorates. -- The American Founders group previously discussed is a typical example; other groups center around banking institutions, such as the group affiliated with State Street Investors Corporation.

(3) Concentration of investment in the American field. -- It is only natural for an investment trust organised in a particular country to place the bulk

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of its funds in domestic securities. The management is more familiar with the domestic enterprises. There is greater certainty of making sound investments and securing profits at home than in unfamiliar foreign fields. Furthermore, to go heavily into foreign securities necessitates a large and expensive staff of experts. Even the British trusts which make international diversification a cardinal principle, place the bulk of their funds in securities within the British Empire. A recent analysis of 19 British trusts showed 42 per cent of their portfolios so placed.[36] American trusts are likely to show a greater percentage in respect to securities originating in this country. There are reasons for the American practice. In the first place, it takes some time to build up a foreign department, and in the second place, the best and most numerous investment opportunities have recently been here in the United States. Some trusts even limit their portfolios to this country. This is unwise. The economic world still has the cyclical habit, and there will surely be times when American trusts will be glad to buy and sell on the foreign bourses.

(4) Concentration of investments within a restricted industrial area. -- Trusts have sprung up which not only confine operations to the domestic field,

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but which specialise in the securities of one or two industries within that field. As mentioned above, there are trusts which specialise in utilities, oils, banks, and aviation. The argument advanced in favor of these trusts is that more careful selection can be made through specialisation, that spreading out over too wide an area will lead to unintelligent and haphazard selection. There is some point to this argument, but no matter how skilled the management may be within its narrow field, the strength of the trust is impaired by the limited diversification of its portfolio. And there are likely to come times when even the best management will find opportunities scarce in its selected field, and the trust would gain much more by commitments elsewhere.

(5) Predominance of common stocks in the portfolio. -- There are two reasons for this, first, the great corporate earnings of the past few years have been reflected in rising stock prices and increased dividends; and second, the general acceptance of the theory that well-selected common stocks make a better long-run investment than bonds. The essence of this theory is that stock values and returns tend to increase with the economic growth of the country, and that common stock earnings keep pace with rising price levels, thus preventing decline in

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the purchasing power of the investor's income. This theory is sound when properly interpreted, but it does not imply that overvalued stocks are good investments or that stocks are always better investments than bonds. The American public recently went crazy on common stocks and has not yet recovered.

(6) Emphasis on profit-taking through sale of securities. -- When the British trusts sell a security at a profit it is usual to retain the entire proceeds in the trust. The profits enlarge the fund as a whole and eventually the stockholders receive increased dividends through the enlargement of their equities. If the surplus built up in this manner becomes too large the excess may be distributed in cash or as a stock dividend.

The American trusts have not been so conservative. They have emphasised profit-taking much more than have the British trusts, and they tend to distribute a large part of their earnings immediately. The earnings of 15 trusts in 1928 showed that profits from sale of securities amounted to 57 per cent of earnings.[37] Some trusts have been able to distribute a large share of such profits and build up sizeable reserves at the same time. This condition has been due to the rising stock markets of the past few years. Profit-taking opportunities have

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been numerous, and actual profits enormous. Other trusts have done little in the way of building up reserves, most of the profit has been paid out. This practice has frequently been due to the fact that in some trusts the management derives its compensation from stock ownership, and in many such cases the managers and promoters have gathered in all that they could.

This writer does not believe that recent opportunities for profitable sale of securities will continue on such a scale. The trusts will have to give more attention to straight investment return and less to buying and selling. Those trusts which have paid out all of their profits will have to mend their ways, and the others will find it necessary to put an increasing percentage of their profits into reserves and pay a smaller proportion in dividends.

(7) Complexity of capital structure. -- This has been mentioned before. American corporate trusts are likely to show several classes of debentures, common stocks and preferred shares. Preferred and common stocks are frequently sold in units. Convertible features, rights, and warrants are common. All this is incidental to the developmental period. There has been an enormous selling pressure behind the investment trust movement,

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and appeals have been made to every type of investor. It is to be expected that as the investment trust grows to maturity there will be a great simplification and standardisation of the capital structure.

(8) Varieties of management compensation. -- In Great Britain the directors and managers of investment trusts receive a salary or a fixed fee. But they derive most of their income through the ownership of stock purchased on the same terms as other shareholders at the time if issue.

Here again, American practice offers variety. In the case of the unit-share trusts the organiser-managers are compensated by a marketing profit. That is, the certificates of participation are sold to the public at a price representing the market value of the underlying securities plus a certain added percentage. From this percentage the organising group pays all expenses and derives its business profit. In the case of the trusts having constant supervision the annual fee is most used. The trust contracts with a management company which agrees to supervise the trust portfolio in return for a certain percentage(usually ½ of 1 per cent)of the total fund. Other methods may be used instead of or in conjunction with the fee. In some instances managers and promoters

get a special type of share; in others they may acquire common stock as a bonus or at a special price; sometimes they possess the right to subscribe for stock at stated prices over a period of years. There is no uniformity, and in this connexion the investor must exercise vigilance. He must watch out to see that managers and organisers do not receive undue returns at his expense.

Trusts and the Stock Market

Any account of investment trust development in the United States must consider the influence of the great stock market boom that began in July, 1927 and continued practically without interruption until the crash in October, 1929. In July, 1927 the Federal Reserve Banks initiated a new policy of low rates, and under the stimulus of easy money there was a great uprush of stock prices during the second half of the year. Advances in bank rates and sales in the open-market brought about a mild recession in the early months of 1928, but by March the decline had stopped and, led by sensational advances in Radio and General Motors, a boom developed. From that time until October, 1929 the market continued merrily upward. Stock values soared to ridiculous heights, but the public continued to buy. The enormous volume of purchasing by an optimistic public was the feature of the

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boom. In April, 1928 a writer in the Annalist commented as follows: "Apparently the whole country had gone on a wild speculative debauch . . . . Over the whole range of the social and financial scale . . . . everyone was trading in stocks."[38] It seemed that stock prices would go upward forever, and new financial prophets arose to herald the advent of a new era of high stock values. But it was apparent to any sensible economist or investor that stock prices had risen beyond reason and that a reaction was inevitable. Also in April, 1928 Professor O. M. W. Sprague remarked, "There has certainly been no change in the prospective earnings of business to provide support for recent advances . . . . The present security market exhibits all the familiar earmarks of inflation and the symptoms of a speculative craze. It presents a situation altogether analagous with that in the commodity markets throughout the world during the twelve months preceding the debacle in the Spring of 1920, and not unlike the Florida land boom of more recent memory."[37] The market held up longer than anyone expected, but a reaction was inevitable. It came in October, 1929, in the greatest stock market crash of history.

What did all this have to do with the investment trust movement? There are three general relationships:

[38] Axe, E. W. A Manipulated Stock Market Offers Prospect of Heavy Loss to the Public, 31 Annalist 688-90 (Apr. 20, 1928)

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(1) The growth of investment trusts was greatly stimulated by the rising market.

(2) The purchasings of the trusts reacted upon the market itself.

(3) The crash furnished a severe test for the trust managements.

Investment trusts in America had a sensational growth during 1928 and 1929. It seems certain that the extraordinary nature of this growth was due to the rising markets of those years. The public was crazy to buy; it would buy almost anything at all. Sales resistance was low, making the flotation of investment trust securities comparatively easy. Companies were formed by the dozens, and their offerings were immediately snatched up. The Commercial & Financial Chronicle gives a grand total of all new capital flotations in 1929 as $11,604,174,935, of which $2,227,730,898 represents investment trusts, trading companies, and holding companies.[40] The greater part of the figure was undoubtedly investment trust securities. The monthly figures show heavy flotations in the first quarter, a lull during the next, exceedingly large flotations in the three months up to the crash, and a sharp decline afterwards. The statistics follow:[41]

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April	82,058,000
May	78,206,200
June	73,406,224
July	220,588,090
August.	453,727,220
September	529,237,100
October	78,637,816
November.	3,435,000
December.	8,639,110

If the trusts were selling so heavily to the public they must have done an almost equally large amount of purchasing themselves. It seems apparent that the investment trusts exerted a real influence on the bull side, and it is possible that they were influential in prolonging the bull market through 1929. Some have gone so far as to assert that the investment trusts were responsible for the 1929 market. This can hardly be true. As large as the investment trust buying was, it was but a fraction of the total. The trust purchases could not have supported the market, let alone force it up. And it is a known fact that many of the trusts were unloading during 1929, thus exerting a force in the other direction. When anything goes wrong there is always a general search for a goat. The investment trusts have been a favorite. Their purchases have been blamed for the rise, and their sales for the crash.

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Just how the trusts weathered the panic is not known. Those holding large amounts of overvalued securities were certainly in an uncomfortable position. Companies having high ratios of fixed-charge securities and depending on turnover profits to carry them through were probably hard hit. There were rumors of weak trusts asking to be bought up by the strong groups. There is no way of telling just what did happen. The results that have appeared have been distinctly favorable. Reports received up to the first of February, 1930 showed that the bulk of the trust portfolios were in the very best of common stocks, and that many of the trusts were in a strong cash position at the time of the break, having sold out previously at a profit and ready to pick up the bargains.[42]

The Immediate Future

It is, of course, not possible to chart precisely the course of investment trust development in the coming years, but a number of general predictions seem warranted:[43]

(1) Growth will be much slower. -- The abnormal stimulus of the rising stock market will be gone, and the securities of the present trusts have yet to be entirely absorbed. With profit-taking possibilities

[43] Cf. Investment Trusts Have Met First Test, 10 Barrons 8, (January 6, 1930); and Steiner, W. H. Investment Trusts, p. 314-6

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scarcer and the public less eager to buy, the investment trusts will return to a process of slower and more normal growth.

(2) Integration will continue. -- Many of the smaller trusts that were able to stand alone during a period of rising prices will not find things so easy in an unsettled market. The need for the superior management and financial strength of the big groups should bring many of the smaller trusts into close relationships with the larger organisations.

(3) Investment policies will be more conservative. -- The emphasis of American trust management has been on turnover profit to the neglect of straight investment return. With the market in a more normal state, possibilities of turnover profit will dwindle, and managements will be glad to look around for profit to be gained through careful selection for higher yields.

(4) Portfolios will show a wider diversification. -- Although investment opportunities in this country are still large, the sudden slump in stock prices is likely to cause many managements to look around to see if investment opportunities are not to be had elsewhere in the world. It also seems likely that trusts overloaded with high-priced stocks may think it wise to

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buttress their portfolios with a good selection of bonds.

Regulation

Although the investment principles underlying the investment trust are sound, the device itself is open to abuse. In a period of rapid expansion and uncritical purchasing it is comparatively easy to launch fraudulent schemes in the guise of investment trusts, and it is especially likely that trusts will be formed under management that is well-intentioned, but weak and incompetent. As far as this writer knows, cases of actual fraud have been infrequent, and although the number of poorly managed trusts is probably considerable, the real state of affairs will not be known until all the 1929 statements are in. But at any rate there has been agitation among legislators and state security commissioners for laws that will protect the public from fraudulent and unsound enterprises.

Before considering public legislation, however, the attitude of the New York Stock Exchange will be stated. The market for investment trust securities is at present over-the-counter, but some are found on the Exchange, and others may follow. It is evidently the desire of the Stock Exchange authorities to keep the securities of un-

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sound trusts off the board, and on June 6, 1929 requirements for listing were published. The chief stipulations are summarised as follows:[44]

(1) Companies applying for listing must be "engaged primarily in the business of investing and reinvesting in the securities of other corporations for the purpose of revenue and for profit, and not in general for the purpose of exercising control."

(2) Companies which apply for listing must be of the general management type, i. e., constant supervision of the portfolio by a management with fairly wide powers.

(3) The true nature of the management must be revealed as well as the basis for compensation.

(4) All expenses incurred in selling and organisation must be shown and excessive costs in these respects will be considered as a bar to listing, as will also a large unfunded debt.

(5) Trusts with any non-voting stock must accord to that stock the right to vote when preferential dividends for one year are in arrears, and such powers are to continue until the arrears are liquidated. "No non-voting stock will be listed unless substantially preferred as to both dividends and assets."

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(6) Annual statements must be submitted and must show gross earnings analysed to reveal sources, i.e., interest, dividends, profits on sales of securities, profits from syndicate participations, transfers from reserves. Only actually realised earnings to be shown, and stock dividends are not to be considered as income.

(7) Securities must be valued at cost and a footnote must show current sales and the difference between these and costs.

(8) A complete list of holdings, giving names and quantities must be submitted.

(9) Where there are subsidiaries, a consolidated balance sheet and earnings statement must be shown, as well as a complete statement for each subsidiary.

(10) "Applicants must agree not to pay any cash or stock dividends on common stock, when such dividends, plus any amount by which the value of securities held shall be less than their cost, exceed the earned surplus and undivided profits."

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the nature of public regulation relating to investment trusts is a field of controversy. Public regulation may proceed along three lines. It may attempt to prevent and punish fraud in investment activities; it may force the publication of such essential information as will enable investors to reach sound conclusions as to investment value; and it may attempt to set up standards of management to which investment trusts must conform. This writer is in accord with the first two objectives, but is opposed to the third. Every precaution should be taken to prevent fraudulent enterprises from getting under way, and no company unwilling to give sufficient information for sound investment analysis has any economic justification for its existence. But for the state to prescribe standards of management is going too far. First, no accepted standards have been completely developed in the United States; second, even though there is a trend toward standardised practice, the science of investment can never be reduced to rule of thumb; third, the successful administration of an enterprise in a dynamic economic society depends in a considerable degree on freedom from hampering regulation; fourth, conformance to legal requirements is no guarantee of the integrity of the management, unscrupulous managements can do much evil while adhering to the

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letter of the law; fifth, conformance to legal requirements would tend to be accepted by the public as prima facie evidence of economic soundness. It may be added that any regulative measures undertaken by the separate states would lead to the same sort of thing that has happened in the case of general corporation laws. Some states will be lax in their requirements, and there will be a tendency for trusts to form in the states of the least restrictions, thus defeating the measures of the more exacting states. The only real solution would be a Federal law, but co-operation between state security commissioners may be of some value in bringing uniformity.

The controversy over regulation assumed sizeable proportions during 1928 and 1929. In October, 1928 the Committee on Investment Companies reported at the convention of the Investment Bankers Association of America as being distinctly opposed to any legislation that attempted to set up standards or to hamper able management. It recommended increased powers of investigation for security commissioners and a substantial measure of information in prospectuses of investment trusts. The required information would be:[45]

"(1) Complete list of officers and directors.

(2) The outline of the plan of capitalisation.

[45] 127 Chronicle 40 (July 7, 1928)

(3) Whether the securities offered are secured by any lien or represent merely a general debt.

(4) Whether there are in existence any liens upon the assets.

(5) What restrictions, if any, exist regarding the investment powers of the management.

(6) Whether audited statements will be published, and, if so, how frequently, and to what extent information will be released."

This is quite obviously a conservative stand. The rules of the California Corporations Commission go to the other extreme. Some of the chief requirements are summarised as follows:[46]

(1) Those connected with the business must qualify as to character and competency.

(2) A complete description of methods of operation must be submitted.

(3) No limit shall be imposed as to the scope of diversification.

(4) The funds of the trust are to be confined exclusively to the investment and reinvestment in securities that are sound, seasoned and marketable.

(5) Organisers must put up at least 20 per cent of the initial capital.

(6) Not more than 5 per cent of the investment fund is to be in the securities of any one corporation

[46] 126 Chronicle 3383 (June 2, 1928)

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(7) Not more than 20 per cent of trust resources are to be invested in enterprises which have not been operating successfully for at least three years.

(8) Semi-annual financial statements are to be issued accompanied by a list of all securities held at the time and dealt in during the preceding period.

(9) 10 per cent of earnings must be set aside before dividends until the reserve equals 25 per cent of paid-in capital.

This subject of regulation will be pursued no further. For a while it appeared that this controversy would assume major proportions, but the issue has apparently subsided. There seem to be four reasons: (1) the scarcity of really fraudulent schemes, (2) the stock market break which checked the rapid growth of the trusts, (3) the successful operation of the majority of the trusts, and (4) the large amount of essential information furnished by the trusts on their own initiative.

Present state Blue Sky laws should prove adequate to check worthless and fraudulent ventures. Severe regulations of the California type lean too far in the direction of unwise paternalism, and are subject to criticism on the five points given above. Paternalism

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may be an excellent thing in some lines of economic activity, but not in the field of investment which is vast and intricate. The only real safeguards here are intelligence, insight, and constant vigilance on the part of the individual investor. If state pressure is to be brought to bear at any point, it will probably be most needed in the matter of requiring publicity. Maybe the leadership of the better trusts will cause the rest to follow, but if not, it may be necessary to force delinquents into line. What the investor needs and wants is not statutory protection, but a chance to find the facts.

Economic Significance

A consideration of some broader aspects of the investment trust movement will conclude this paper. It is apparent that the investment trust has certain merits as an investment device, but has it any further value? Does it contribute anything to general economic well-being and progress? This writer believes that it does. It should exert positive economic influence in three directions:

(1) As a factor making for steadiness in the stock market. -- Extreme peaks and depressions in the market are a disturbing influence on business. They are largely the result of alternate bull and bear stampedes.

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The investment trust should provide a steadying element. First, impartial investment management is not likely to be stampeded into unthinking excesses of buying and selling; and second, clear-sighted management will tend to unload overvalued securities as a peak is neared and to make substantial commitments when the market is in a slump. Thus the trusts will not assist headlong movements in one direction or the other, but will tend to exert pressure in opposition.

(2) As a factor making for an increase in the amount of capital. -- It is an economic commonplace that industrial progress is much dependent on an ever increasing supply of capital goods. The investment trust should aid accumulation, especially among the classes with small or moderate income; first, by preventing a waste of capital, and second, by stimulating thrift. Many millions of dollars go yearly into fraudulent and doubtful enterprises. The small investor has sought a high return, but there has been little means of getting it outside of chance-taking in low-grade securities. The investment trust affords an opportunity for the small investor to purchase sound securities protected by diversification and yielding investment profits. With this new channel opened up, more savings should find their way into pro-

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ductive enterprises. At the same time, and for the same reasons, the investment trust should stimulate some increase in the general volume of savings.

(4) As a factor making for a more equitable distribution of wealth. -- Karl Marx based his whole social theory on the assumption of an inevitable conflict between workers and capitalists. With advances in the technique of production, increasing profits went to the capitalists while the return to labor was constantly maintained in the vicinity of the subsistence level. Through the institution of private property whereby the capitalists controlled the means of production, they occupied a superior bargaining position and could exploit the worker by forcing on them an unfavorable wage contract.

The high wages and wide diffusion of profits characteristic of the present economic order have largely confuted the doctrines of Marx, but modern economic society has yet a long way to go in the matter of distributive justice. As Professor Dewing has said, "Industry has been autocratic in its administration and in the distribution of its profits. The general public has not participated in the control over the profits of industrial, railway and public utility enterprises."[47]

The investment trust enables the wage earners

[47] Dewing, A. S. Investment Trusts: Effect on the Public, Boston Transcript, Part II, p. 8 (April 27, 1929)

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SUMMARY

PART I

The investment trust is what its name implies, a means of investment; that is, of the commitment of funds to productive enterprises in expectation of moderate, regular return and safety of principal. It is distinctly not a speculative device nor a means of co-operative gambling, though there are schemes for such purposes that have a surface resemblance to genuine trusts.

The elements in the investment return are interest, risk premiums and profits. In order for the risk premiums to be truly compensatory, it is necessary to diversify the investment fund, to so spread commitments that the aggregate losses are balanced by the aggregate risk premiums. Profits are the fruit of skilled management which uncovers undervalued securities, avoids overvalued ones, gets into stocks at the bottom of the business cycle and into bonds at the top. Also it exercises vigilance to keep the fund intact, shifting from declining enterprises and industries to those on the up-grade.

The wealthy investor has a fund large enough to effect diversification and to command skilled management. The small investor has not been able to do so.

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The investment trust affords an opportunity for small investors to pool their resources and create a large fund which means safety through diversification and profit from expert management.

PART II

Great Britain is the home of the investment trust. In the Nineteenth century that country had a heavy favorable balance of trade and a large supply of capital. Foreign yields were attractive, rates at home were low. After disastrous speculation in the first half of the century, investment trusts were developed as a medium of foreign investment, but they were not free from mismanagement, and it was not until the end of the century that they reached a sound basis. Since then they have prospered and multiplied.

British trusts were first organised under ordinary trust agreements, but were later formed as joint-stock companies under the Companies Acts.

Management has become sound and conservative, adhering to the principles of world-wide diversification, avoidance of over-concentration of funds, avoidance of controlling interests, and the holding of marketable securities. The British trusts secure a large part of their capital from the public sale of debentures which are

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protected by large stock equities. Reserves are built up, dividend policies are cautious, management expenses are kept down. The British trusts have proved their worth by the excellent fashion in which they came through the crisis of the World War.

PART III

The United States has witnessed an extraordinarily rapid growth of investment trusts within the past five years. They have not grown up as a means of foreign investment, but as a channel for domestic commitments. The stimulus to American growth has been the economic prosperity of recent years. There has been a great increase in savings, bringing thousands of small investors into the market. They have been lured by the high earnings of corporations, but they are lost in the maze of modern corporate securities. The investment trust has enabled them to secure the investment guidance and management that they need; and the sellers of securities have been only too anxious to utilise the device.

American finance has developed a diversity of types. The major classification is between the contractual type in which the portfolio of the trust is owned directly by the security holders and the statutory type where the portfolio is owned by the trust, and the

trust in turn by the security holders.

The contractual type is subdivided into unit-share and fund types. In the former the security holders hold pro rata shares in certain specified blocks of securities which may be redeemed under certain conditions. The element of management is small. In some the underlying securities are never touched, in others there is some provision for shifting and supervision of the fund.

The fund type is similarly organised, except that the security holders have pro rata shares in a general undifferentiated fund instead of in specific blocks of securities. In the fund type the management element is usually more pronounced.

The statutory types are generally organised as ordinary corporations or as Massachusetts trusts. Here the management of the portfolio is continuous, and the element of managerial discretion large. The trust is operated in the manner of any ordinary corporation, the security holders standing in the same relation to the trust as the stockholders of any industrial corporation. The trusts of the statutory type have outdistanced those of the contractual type.

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own controlling interests in several subsidiaries to which the parent company furnishes investment service in return for a fixed fee. The trusts tend to form into groups knit together by stock control, interlocking directorates, and investment service contracts.

The American investment trusts present a number of general characteristics differentiating them somewhat from the British organisations. These characteristics are: close relations between many investment trusts and banking institutions; concentration in groups; confinement of investment to the domestic field; confinement of investment to one or two industries; predominance of common stocks in the portfolios; emphasis on turnover profits; complex capital structure; and varied schemes for compensation of management.

The recent stock market boom was an important factor in the investment trust growth. The rush of thousands to purchase securities made easy the sale of investment trust securities.

The crash furnished a severe test for the trusts, but they seem to have weathered it well. We may, however, expect a more slow and conservative growth in the immediate future.

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the public has lead to agitation for state regulation. It seems wise to enforce present Blue Sky laws and to exact publicity from the trusts, but any attempt to impose precise standards is of doubtful value. The demand for legislation has somewhat died down with the return of the trusts to more normal growth.

The investment trust has a general economic significance: (1) as a steadying force in the stock market, (2) as a stimulus to capital accumulation, and (3) as a means of widespread distribution of industrial profits.

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